Why UK banks are like public utilities – and should be regulated as such

*Banks have economic features similar to those of utility service providers – which are typically regulated more heavily than other companies – writes **Phil Molyneux**. He explains how banks ought to be regulated with this point in mind, and concludes that greater regulatory oversight of bank pricing and service provision is necessary.*

It has been nearly a decade since the global financial crisis rocked the banking world, collapsing major banks, resulting in massive taxpayer bailouts. Since then UK banking has been impacted by a variety of other shocks including fallout payment protection insurance (PPI) mis-selling and Libor, and other rate fixing scandals. Put short, it has been a litany of disaster.

Problems in UK banking

Post global financial crisis, the UK economy has been slow to grow despite accommodative monetary policy (low interest rates and quantitative easing). Banks have also been hit by a host of regulations aimed at de-risking their business and improving overall soundness and governance. This has added to costs and dragged down profits. Royal Bank of Scotland remains 71% owned by the taxpayer, while in May 2017 it was announced that the last government's holdings in Lloyds had been sold to the private sector.

But there are other issues rumbling on, and these vary bank by bank. Barclays is (still) in legal wrangling with regard to the support it received from one of the Qatari sovereign wealth funds during the crisis. HSBC was recently fined $175million by the US Fed for 'unsafe and unsound practices' in its FX trading activities – it was also fined a lot more (with five other banks) for similar in 2014. We could go on. The regulators have been successful in boosting banking system soundness and limiting excessive risk-taking, although the jury on improving bank conduct is still 'out'.

The problem for the top banks is that they are now highly constrained by tougher regulations restricting their risk-taking (capital and liquidity requirements have increased markedly since the crisis). Adhering to regulations – so called compliance costs – have exploded. The sluggish economy and low interest rate level also do not help – faster growing economies and higher interest rates always boost bank profits. So, UK banks are constrained and have limited growth opportunities. All these factors together mean that returns (ROE) have been consistently single digit over the last five years and prospects (especially with Brexit) remain muted.

The top banks remain big. HSBC has consolidated assets size close to that of the country GDP (£2.1 trillion). Barclays was just as big a few years back but it has shrunk to now around 60% of the size of the economy. RBS and Lloyds follow on behind with balance sheets about 40% of UK GDP. Totting up just for these four banks shows that combined they are nearly 2.5 times the size of the UK – so they still pose a potential systemic threat as any failure would have such serious repercussions that the state would still have to step in to bail them out.

As already noted, numerous new rules have been put in place to limit bank operations including moves to remove executive excesses by curtailing their remuneration packages. All these place a straightjacket around banker's activities and as a consequence inhibit their freedom, and this new environment has led some to talk about banks being no more like private free-wheeling profit-maximising firms, but more like public utilities. Or to put another way, their services are so important to society that they should be regulated much more heavily – just like water, electricity, and other utilities.

Credit: Pixabay/Public Domain.

Why banks are like public utilities

Public utilities have various economic features that explain why they are typically regulated more heavily than other companies. Typically, these businesses have a common network structure – they have extensive distribution systems (think of piping for gas or cabling for electricity) that involve significant investment (known as large sunk costs) that can be government- or privately-owned. Operations of utilities usually can be characterised into production, transmission, and distribution. These three stages can be owned by public or private firms.

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 online portals and branches. These stages are typically all privately owned although in some countries (such as Brazil and China) state ownership remains important.

Why we regulate utilities?

There are three reasons why we regulate utilities.

1. Public utilities are natural monopolies which means that they realise scale economies indefinitely, ultimately leading to one firm in the industry. In natural monopoly, productive efficiency is achieved with one firm. Because utilities tend to be natural monopolies, consumers need to be protected against aggressive pricing (known as gouging) and other bad treatment, hence the justification for regulation, particularly on their pricing, products, and treatment of customers. As noted above, the top 4 UK banks are around 2.5 times the size of the UK economy – handful of banks dominate the system. There have been moves to encourage the set-up of new 'challenger' banks to try and boost competition and reduce the dominance of the Big 4. Metro Bank in 2010 was the first to obtain a full banking licence in over a century and six new banks have been authorised by regulators since April 2013. Despite these new banks, it is by no means certain whether they will be able to disrupt the status quo;
2. To stop regulators from being captured by producers**.** The aim here is to protect all producers and not just the biggest, by making sure utilities do not write their own rules. One could argue that in banking this is too late: big banks for years have helped write the rules for domestic regulators. The big banks dominate all areas of retail and wholesale activity – they know more than regulators. Big banks also gain from (implicit) safety net benefits (too-big-to-fail banks are bailed out in the event of a crisis);
3. Utilities have particular economic features. Namely, the lowest cost operators are likely to be biggest rent gainers and can extract significant monopoly profits. Also, utility business tends to have a high level of cost-based cross-subsidization. Also monopoly rents are likely to be spread among a handful of key groups. In banking it's easy to point to examples of previously found anti-competitive pricing behaviour (lending to

> small businesses and retail payments) in the UK. Cross-subsidization is widespread (we have seen cheap retail depositors subsidizing investment banking arms of the big UK banks prior to the crisis). And who has been the key groups benefiting from their operations?: mainly bank executives and shareholders. When banks perform well these benefits are rarely passed onto customers in the form of lower fees or loan rates or higher deposit rates.

UK banks as utilities

Bank size still remains an issue with the 4 big banks having combined assets two and half times larger than the economy. All four still pose a potential systemic threat and so they have to be regulated accordingly. Since the global financial crisis they have been de-risked, with tougher capital, liquidity, executive pay, and other rules curtailing their activities. Banks are no longer free-wheeling 'masters of the universe' – they have been forced to become more conservative institutions with much greater government oversight. Returns have been reduced so much that even these now resemble the heavily regulated low returns of utilities compared to old style banks. There is evidence of regulatory capture (or at least barriers to capture are low), cross-subsidization is widespread and there are still pockets of monopoly rent-seeking (the UK competition authorities investigated small firm lending and retail payments again, in 2015, finding evidence of price gouging).

All these factors justify banks being regulated more like public utilities – and particularly in the pricing and service quality areas.

Note: the above draws on the author's article published in the *Journal of Economic Policy Reform*.

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