



4 November 2010

Dear Sir John,

### **Response to Call for Evidence in the Issues Paper**

I am writing in response to your Issues Paper and Call for Evidence of 24 September. Although I must emphasise that the views in this letter are my own, based on my past experience as CEO and chairman of the Royal Bank of Scotland, I have also drawn on discussions that I have held in my role as Chairman of the Scottish Council of Economic Advisers.

The Council was established in June 2007 by the First Minister of Scotland to provide advice on increasing Scotland's sustainable economic growth rate. The Council consists of eleven academics and business leaders who have a collective interest in achieving what is best for Scotland. We meet several times a year and publish an Annual Report.

Over the past few years we have had several discussions on banking and published recommendations on the financial services sector in our Second Annual Report. During these discussions recurring issues on the banking sector have emerged which I would be happy to discuss in more detail.

### **Lack of access to finance for SMEs**

Government investments in financial institutions are managed by UK Financial Investments Limited (UKFI). The overarching objective of UKFI, as stated on its website, is:

"to protect and create value for the taxpayer as shareholder with due regard to the maintenance of financial stability and to act in a way that promotes competition.

This includes:

- maximising sustainable value for the taxpayer, taking account of risk;
- maintaining financial stability by having due regard to the impact of its value realisation decisions; and
- promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions."

From speaking to CEA members who are business leaders, it is clear that the latter objective is not being achieved. They report that the banks in which the UK Government has substantial investments are not competing effectively and are not providing money to SMEs or even quite large companies. When finance is offered it

is at margins above those of the bond markets along with extortionate fees. The situation shows no signs of improving. Larger companies are increasingly approaching bond markets to raise finance as they offer cheaper finance, longer terms and less hassle. However, it is not possible for SMEs to raise funds in this way as the minimum raised in this manner is typically £100 million.

### **Measures to reduce market concentration**

While again emphasising that this is a personal view, I do believe that in the interests of competition, the merger of HBOS and Lloyds was misconceived and Lloyds Banking Group should be broken up. Under normal circumstances this would never have been allowed and nothing has happened since to make the decision any more correct. Obviously there would be costs associated with such a move but the merger was fundamentally wrong for several reasons – competitive, cultural and commercial – and as such should be reversed.

A further consideration might be the separation of HBOS into its original constituents, Halifax and Bank of Scotland. This merger was never satisfactory and its demise could create two separate entities – Halifax (a 'narrow bank') and Bank of Scotland, a full commercial bank genuinely head-quartered in Scotland. Bank of Scotland would then form part of an improved business support structure for Scottish businesses.

In addition, the Independent Commission should seriously consider requiring RBS to sell off all of its insurance business and to split into two separate banks – which would be RBS and NatWest with RBS headquartered in Scotland. This action along with the split up of Lloyds Banking Group proposed above would lead to significantly improved competition.

### **Diminishing financial services sector in Scotland**

Another concern I have is that although two banks are nominally headquartered in Scotland – Lloyds Banking Group and RBS – in order to speak to senior personnel it is necessary to travel to London. Without a true Scottish bank, there is diminishing support for Scottish businesses. This is having a detrimental knock-on effect on the supporting service sector infrastructure in Scotland.

### **Separation of retail and investment banking**

Most people agree that there will always be banks that are too big to fail in the sense of failing to meet their obligations to depositors (but not share or bond holders). It is my personal view that if this is the case it should be recognised as such and be explicitly guaranteed. If this is not the case this should also be made explicit. There should be no such thing as 'implicit' guarantees.

It is also my view that banks, with portfolios containing substantial amounts of proprietary trading, should not be allowed to be of a size that poses a systemic risk. Banks enjoy such a guarantee should not be trading on the national balance sheet. The implications of this, such as separation of retail and investment banking functions, living wills etc., have been widely discussed.

The establishment of a greater number and diversity of financial institutions would serve the interests of both financial stability and improvement of services to customers. As part of restructuring, ambiguity about the scope of government guarantees should be removed, and market counterparties should understand that there is no government indemnity of the trading activities of large financial institutions. These objectives are likely to require firewalling of the state guaranteed retail deposit base of major banks, separation of proprietary trading activities from the provision of other financial services, and limit on the size of proprietary trading institutions.

### **Separation of borrower from owner of the debt**

I would like to draw attention to the additional risk to the financial system posed by the separation of the borrower from the debt owner that has resulted from securitisation and bond issuance. The problem is that in the event of failure the possibility of negotiating the least damaging outcome is hugely decreased. I believe this merits further investigation by the authorities.

I would very much welcome the opportunity to discuss these issues further with you.

I understand that other members of the Council would also be delighted to meet to discuss their own personal views which in some cases differ substantially from my own.

Yours Sincerely,

A handwritten signature in black ink, appearing to read 'G Mathewson', written in a cursive style.

SIR GEORGE MATHEWSON