

city limits
the
progressive
case for
financial
services
reform

Kitty Ussher

Open
Left

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First published in 2011
© Demos. Some rights reserved
*Magdalen House, 136 Tooley Street,
London, SE1 2TU, UK*

ISBN 978 1 906693 64 0
Series design by modernactivity
Typeset by Chat Noir Design, Charente
Printed by Lecturis, Eindhoven

Set in Gotham Rounded
and Baskerville 10
Cover paper: Flora Gardenia
Text paper: Munken Premium White



CITY LIMITS

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Acknowledgements

This work has benefited enormously from the support and experience of numerous practitioners and experts, from the top of high finance to frontline retail workers, who have generously given their time through personal interviews, group sessions, by attending our brainstorming seminar held in December 2010 or by commenting on earlier drafts. Where appropriate, the anonymised contributions of those we have spoken to are included in the text.

I am particularly grateful to: the City of London Corporation for its financial support and helpful suggestions, the Association of British Insurers for hosting our brainstorming seminar, James Buckley for his help with the European chapter, Jonathan Edwards for his general research support and editorial assistance, and my predecessor as Director of Demos, Richard Reeves, for his enthusiasm for the initial idea.

Having said that, all the views, conclusions – and errors – are entirely my own.

Kitty Ussher
March 2011

Introduction

The activities of what we now call the financial services sector have always aroused strong passions. Dante's *Divine Comedy* condemns the 'usurers' to the inner ring of the seventh circle of hell. Three hundred years later, Shakespeare described how Shylock had to forsake his trade as a moneylender, to be redeemed in the climax of *The Merchant of Venice*. The Bible tells the story of Jesus ejecting the moneylenders from the temple; Islam has through the ages prohibited the paying of interest.

Notwithstanding these religious and cultural references, the current standing of the financial services sector in society feels near an all-time low. The public blames the bankers en masse for the financial crisis that began in 2007 and the subsequent recession. This suits the politicians as it shifts the blame away from them and gives an opportunity to load additional taxation on the sector. Indeed, some opinion formers have argued that there is a need to 'rebalance' the UK economy away from financial services.

This pamphlet discusses whether any of these reactions are sensible, or indeed in the national interest. It seeks to improve the clarity of thinking on the debate on the future of the banking sector in Britain, providing evidence to the ongoing Banking Commission chaired by Sir John Vickers. It moves beyond the rich and detailed work being undertaken by regulators at home and abroad to improve the risk management and resilience of individual banks. Instead, it attempts to offer some UK-specific policy lessons to be learned from the crisis as witnessed first hand by the author, who served as City minister from June 2007, when the problems at Northern Rock began to crystallise, to October 2008, just as Lehman Brothers collapsed.

This experience is supplemented by the views of dozens of experts – regulators, practitioners and frontline financial services

workers – who were interviewed during the course of the research. Where appropriate, their anonymised voices are heard in the chapters that follow. By proposing specific policy recommendations, the ultimate aim of the pamphlet is to help build a more resilient economic system, which is better able to support people as they live their everyday lives.

The pamphlet is called the ‘progressive case’ for financial services because it is deliberately pitched to provoke debate among those who would call themselves progressives, of which the author is one. It is right to have a public debate about creating greater stability in the banking sector but it would be wrong for that debate to be informed by gut mistrust or unease about the financial markets and how they work. Many who call themselves progressives would not seek to work in the financial services sector, and as a result there is a gap of trust and expertise between the City and many in Westminster. Yet a strong financial services sector is not only a current reality of modern British life, but also one of the hottest subjects of contemporary public policy discourse as people debate its future. A policy maker who does not seek out information and debate does their citizens no service. Indignation is no substitute for understanding.

These are some questions this pamphlet hopes to provoke:

- Do the benefits of hosting a financial services sector outweigh the potential costs?
- Are we being rational when we talk of ‘rebalancing’ away from financial services and what does this tell us about how we understand and value certain forms of labour?
- Do the traditional industries have more inherent value than any globally competitive skills-based industry?
- What is really motivating the desire to break up the banks?
- Is a debate about the actual size of pay packets more or less important than the circumstances in which those pay awards were made? To what extent does the pay debate distract us from other things that matter such as the resilience of the banks and the structure of incentives?
- What is the role of government to intervene in this area?

- Why do none of the main political parties feel able to set out their vision for the financial services sector; what are they afraid of?

The hope is that the analysis in these pages will give succour to those who wish to engage in these issues and so lance the persistent boil of hysteria and resentment. The policy recommendations are challenging to government, City and public alike. Some are controversial. None are consensual. So one thing is sure: they will provoke debate.

Outline

The pamphlet starts by recapping the causes of the current recession (chapter 1) and why it had such an impact in the UK. This brief recap is important because it is necessary to understand which policy conclusions flow from the events and which do not. To minimise the risk of such events happening again, we make the following new policy recommendations:

- Open up a policy debate in the UK on how to deal with asset price bubbles at a time of low inflation and interest rates with an independent central bank.
- Use fiscal measures such as stamp duty and capital gains tax on primary residences to curb rapidly rising property prices.
- Government and regulators should pay greater attention to the savings ratio, setting a reference rate that if breached sends a warning to the markets of increasing risk.

Turning to issues around corporate governance, we recommend that the pool of trained people available to undertake board-level appointments across UK plc should be increased. Specifically for the financial services sector, the Bank of England should provide an informal, confidential training and mentoring service for non-executives, focusing particularly on those whose backgrounds are from other sectors, to give them a safe place to ask questions and air concerns (chapter 2).

This pamphlet then looks at the wider contribution that financial services makes to UK plc and whether it would indeed

be sensible to ‘rebalance’ the economy. It shows that in recent years there has been little connection between those countries that have high dependence on financial services and their ability to avoid recession. That does not mean that changes cannot be made. For example, we recommend that the Bank of England should purchase more corporate securities and fewer gilts in any future rounds of quantitative easing.

We highlight the crucial importance of the financial services sector in yielding taxation revenues to the state, which can be spent on the government’s priorities, not to mention generating jobs in the centre of London and across the country. There is also strong anecdotal evidence that the existence of a world-class financial services sector in London indirectly benefits other sectors such as manufacturing. In addition, there is strong evidence from the new interviews conducted for this research that the perception of political risk in the sector has risen hugely in recent years, and that this has the potential to reduce the competitive position of London. We conclude that politicians who want to appear tough on the banks would be wise to restrict their comments to strengthening banks as institutions, not weakening bankers as individuals (chapter 3).

Turning to competition issues, including pay and bonuses, chapter 4 shows how the banking crisis was not caused by having banks that were too large and too few, and so it would be illogical to conclude that the banks should be broken up. Instead, it suggests that the real competition issues to be considered are the reluctance of consumers to switch accounts because of the ‘hassle factor’ involved, and potential failings in the labour market that might be restricting access to the high salaries on offer in the City. On pay it draws a distinction between discretionary bonuses, which should be taxed highly, and contracted payment-by-results arrangements, which can be a useful tool of performance management regardless of the sums involved. Recommendations include extending the remit of the new competition authority so it should also look at labour market failures, and a policy distinction between the taxation of discretionary and contractual bonuses (chapter 4).

Chapter 5 discusses an issue that came up repeatedly during the course of the research, but on which UK politicians are strangely silent: the challenge of responding to the rapid increase in banking and insurance regulation originating in Brussels. This chapter concludes with a recommendation that the UK government needs to put a far greater priority on influencing the direction of EU policy rather than continuing its current reactive approach, and should look again at the way in which the new UK regulatory architecture is designed (chapter 5).

Throughout the analysis, the overarching theme is that much of the reaction and debate that has been seen in the media does not directly flow from the evidence of the real strengths and weaknesses in the financial services sector. A clear-headed look at the facts is required, undistorted by the prism of the public mood, in order to ensure that policy changes actually have the desired effect.

Summary of findings

Bubbles and borrowing

The government should stand ready to use fiscal tools to take the shine off asset price bubbles, in particular by varying stamp duty to a far greater extent and introducing – and varying – capital gains tax on primary residences depending on the direction the housing market is taking.

The government should develop an alarm system for too much personal borrowing by setting a reference rate for the savings ratio. A warning designed to unsettle the markets should be issued if this reference rate is breached in the early stages of a boom.

To support the real economy, in any future rounds of quantitative easing, the Bank of England should purchase more corporate debt and less government debt.

Boards and careers

The financial sector should broaden the experience and skills of executive board members to enhance their ability to question and minimise a tendency towards ‘group think’. The government should work with industry to establish a board-level careers service across different sectors where senior individuals, entrepreneurs and leaders from all walks of life can self-refer to receive assessment, experience, advice and training to make them credible candidates for board positions in future.

As part of its new role to monitor systemic risk, the Bank of England should provide an informal and confidential mentoring system for non-executive directors, particularly those from outside the sector, giving them a safe place to test hypotheses and seek analysis and advice.

Careers in the financial sector must attract a broad cross-section of society. The mandate of the proposed new competition

authority should be extended to include considering labour market failure, with a primary focus on access to highly paid professions.

The public eye

It is in the national interest to have a strong financial services sector in Britain, as this will increase taxation revenue and have beneficial direct and indirect economic effects. The government needs to be brave and recognise this. It should set out a clear policy direction to support investment in financial services in Britain, designed to capitalise on strengths and address weaknesses.

Policy makers for the banking sector must emphasise maximising benefit for the future rather than seeking revenge for past failures. There is no immediate case for splitting up big UK retail banks, nor evidence to support splitting investment banks from retail banks.

Politicians who want to appear tough on the banks but not weaken the sector should restrict their comments to strengthening banks as institutions, rather than weakening bankers as individuals.

The government should raise a higher level of tax on discretionary bonuses to bankers (as opposed to other forms of performance-related pay) above a certain value when they are not linked to contracted medium-term outcomes.

Europe

The reforms to the UK regulatory architecture should be reviewed through the prism of needing to maximise UK influence, and minimise compliance burdens, within the European regulatory system.

The government should demonstrate a cabinet-level determination to lead the European agenda on financial services. This should include developing stronger career structures for UK graduates, civil servants and business people seeking to gain experience of working in the European Commission.

1 What happened?

When Gordon Brown became prime minister in June 2007, the Treasury that he left behind was on the whole a confident place. The economy appeared in good shape, with unemployment, inflation and interest rates all at historic lows – a validation, it appeared, of the decision a decade previously to make the Bank of England independent.

The Treasury also had a palpable swagger in its relationship with the financial services sector, having belatedly realised and begun to champion its sponsorship role for the City within government, to positive acclaim from the bankers, who had long struggled to find a friendly ear in Whitehall.

The buzz term used to define this new relationship was ‘principles-based regulation’, a clever phrase chosen to imply not only a light-touch approach that had at its heart an abhorrence of red tape (in contrast with what was perceived by the City to be coming out of Brussels) but also an intellectually superior method of regulation, which eschewed the traditional box-ticking method in favour of broader systems designed to align the incentives of managers with the national interest.

Overall, although often high maintenance, the City was viewed as comprising an important group of stakeholders with whom it was essential to maintain a meaningful two-way dialogue.

Barely a year later, all that had changed. By the end of 2008, the Royal Bank of Scotland (RBS) and Lloyds Banking Group faced no choice but to be partially nationalised in order to obtain the tens of billions of pounds of recapitalisation that they needed to survive. Taxpayers were required to guarantee hundreds of billions of pounds of private bank fundraising, not to mention provide a similar level of insurance to bank assets now perceived as ‘toxic’.

Principles-based regulation ended as the Financial Services Authority (FSA) got far more involved in the detail of companies' business plans and ratcheted up firms' capital requirements. And as the recession took hold, public anger turned on the bankers, who the public perceived were to blame, giving political space in Britain for the imposition of one-off levies on firms that paid bonuses, an initiative that set the tone for similar taxes in other countries around the world.

This complete turning of the tables in the relationship between government and the City in such a short space of time could be used to infer that the previous settlement between the two had been sorely lacking. There were certainly faults in the UK system in the run-up to 2007, which this pamphlet discusses. But that is a different thing from saying that the UK regulatory system in some way caused the crisis. With hindsight, greater foresight by the UK authorities could have increased our resilience to the crash when it came, but could not have prevented it.

The analysis in the first two chapters of this pamphlet shows that there were four main causes of the crisis – or four factors without which the crisis would not have happened. These are:

- the lax regulatory regime, which resulted in loans that were too risky to be made, primarily in the US housing market
- the ability of these loans to be securitised, repackaged and sold around the world
- a failure by management in some, but not all, institutions to understand the nature of the risk they were taking on
- in those institutions that did not understand the nature of the risks they faced, a failure by the regulators to correct their mistakes.

The effect of the crisis was then exacerbated in the UK by the low savings ratio that emerged in 2007–08 and a lack of policy tools to deal with the sharp rise in house prices in the run-up to the crash.

The policy conclusions that flow from this analysis are explored in chapter 2. But first, and by way of introduction, we need to recap what actually happened.

Events

Within weeks of Gordon Brown departing from the Treasury the wholesale money markets began to seize up as major financial institutions began to doubt not only the value of their own assets but also those of their trading counterparties.

The cause of the doubt was a change in the perception of the value of previously fashionable products such as mortgage-backed securities and collateralised debt obligations. There was an emerging realisation in mid 2007 that these had been overvalued, and the risk of default of the underlying assets – typically mortgages that had been sold too casually – had been underestimated.

Although such subprime mortgages existed in the UK, they existed to a far greater extent in the USA, where lighter regulation allowed high-risk individuals easily to acquire so-called ninja (no income, no job, no assets) loans, particularly to buy houses. Indeed the US government had actively encouraged greater lending to low-income families for this purpose. Brokers and lenders had responded with alacrity, particularly as they could offload much of their risk by either securitising the loans, or selling them to other global financial institutions to do the same: the so-called ‘originate to distribute’ model.

This model broke the crucial link that had existed between lenders and borrowers, with the result that originators had little incentive to establish the creditworthiness of borrowers, as they would quickly pass on the credit risk to other institutions. Meanwhile the purchasing institutions did not have sufficient information about the real risk attached to the loans and in any case undervalued that risk in the belief that lower interest rates and rising house prices were simply part of the natural order of things.

When from 2004 interest rates in the USA began to rise, people started to default on their mortgages and because their

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debt was by this stage spread all around the world the ripple effects also began to spread throughout the global financial system. By mid 2006 some institutions had begun to slow their securitisation activities, concerned at the levels of debt; the exposure of HSBC to the US subprime sector was a big business story in the first months of 2007.

Eventually every financial institution was forced to reconsider the value of any assets their trading counterparties owned which were ultimately linked to mortgages, not to mention their own. By August 2007 the problem was so acute that the risks (and costs) of day-to-day lending rose hugely, fear and uncertainty took hold, and the wholesale money markets suffered what was widely described as a 'heart attack'.

While policy makers had been on red alert for some weeks, causing the Governor of the Bank of England, Mervyn King, to regret his recent decision to deprioritise the Bank's work on financial stability, the first time the British public woke up to the fact that something was up was when at 10pm on a Thursday night in late September 2007 the BBC business editor Robert Peston broke the news that Northern Rock had applied for emergency financial support from a reluctant Bank of England. It did not take long for depositors to start queuing up to take their money out.

The problem with Northern Rock was not that it had been particularly strong in the subprime market, but that instead of relying on its own deposit book to fund its lending it relied on the – normally extremely liquid – wholesale money markets. When those markets dried up, the company soon ran out of cash. It also showed how rapidly a private problem can become a systemic crisis in an era of 24-hour news: it was seeing the rolling news pictures of some people queuing for money that encouraged others to do the same.

To stop the run on Northern Rock, the government was required to underwrite its deposits. The government then attempted to find a buyer at a price that protected the taxpayer interest. When that failed, emergency legislation was enacted to nationalise Northern Rock, some six months after the run. Meanwhile, businesses and consumers alike were beginning to

find it hard to obtain credit as banks and other financial institutions became increasingly leery at the prospect of taking on any risk at all, while they scabbled around with regulators and accountants to try and find a true value for various exotic financial products they found to their dismay that they owned. Many institutions had not fully valued their toxic assets until early 2008. And with mortgages increasingly hard to come by, the housing market began to fall in Britain, thereby reducing even further the value of what were soon to be called ‘toxic assets’ on the banks’ books. Confidence was further eroded by the firesale of Bear Stearns to JP Morgan in March 2008; into this maelstrom RBS managed to achieve the largest ever rights issuance a few weeks later, but it was not enough.

A vicious circle then came into play: consumers worried about the fall in the value of their property began to rein in discretionary spending to pay off their debts, leading to fears of a slowdown, which made the banks even more concerned about extending credit. And with credit constrained firms were forced to shelve expansion plans, making many jobs feel less secure, causing consumers again to pursue a more cautionary approach to spending. There was no help from abroad because consumers in the UK’s major trading partners were feeling the same. And so it was that by 2008 the recession became a self-fulfilling prophecy.

In September 2008, just as parts of the market were becoming used to the new world order, the true worth of some of the world’s largest institutions began to bottom out. Within a few weeks it became clear that, despite earlier attempts to prop them up, there were still serious problems at the US government’s monoline mortgage companies Freddie Mac and Fanny Mae, which were bailed out along with the insurance group AIG. Less fortunate were the folk at Lehmans, which was allowed to go under. Merrill Lynch was only saved by jumping into the arms of Bank of America.

Panic returned, threatening the next tier of vulnerable firms and necessitating in the UK an amendment to the 2002 Enterprise Act to allow the acquisition of HBOS by Lloyds TSB to go through in the interests of financial stability. The

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emergency legislation that had enabled Northern Rock to be nationalised was then invoked to allow a partial takeover of Bradford and Bingley by Santander and, separately, the government faced the political necessity of guaranteeing deposits in Icesave following the collapse of the Icelandic economy.

In this new jittery world, the FSA, humiliated by its previous championing of principles-based regulation, ramped up its stress-testing of the financial institutions within its purview, concluding that considerable capital raising was required. But with the markets understandably deaf to pleas by distressed banks for more cash, it had to be the government that offered UK firms a life-line in order to prevent further instability in the market that would ultimately impact consumers: on 13 October 2008 it announced that £37 billion would be used to recapitalise RBS and the merged Lloyds TSB/HBOS in return for appropriate ownership stakes.

At the same time the government also made available (for a commercial fee) substantial credit guarantees to underwrite bank lending, which by the end of 2008 had underwritten debt worth around £10 billion, peaking at £134 billion around a year later. With the mortgage markets seized up, a similar scheme was then introduced to guarantee trades at the top end of the market in mortgage-backed securities. The USA followed suit, eventually passing its Troubled Asset Relief Programme legislation (TARP) to insure up to \$700 billion of troubled assets.

Following a hesitant start in 2007, the Bank of England throughout 2008 and 2009 also made available substantial liquidity to the banking system through its normal operations, the special liquidity system that ran from April 2008 until January 2009 and a permanent discount window facility introduced in October 2008.

By the end of February 2009, the government announced that it had reached agreement in principle with RBS to insure toxic assets worth £325 billion for a fee of £6.5 billion, plus a commitment to lend more into the economy, under a new asset protection scheme (APS) open to all companies. At the same time a further £19 billion was injected into the company.

A week later, Lloyds TSB had also come to the table, with an agreement in principle to insure £260 billion of its assets for a fee of £15.6 billion plus commitments to increase lending to business. But by November, partly as a result of the implicit protection provided by these in-principle agreements, market conditions had improved enough for Lloyds TSB to instead raise on the private markets the capital it needed to compensate for the increased risk it held on these assets.

RBS did proceed with the APS, although with the value of assets protected reduced to £282 billion and a larger 'first loss' to be borne by the company. As a result, by the end of 2009, the government's shareholding in RBS had risen to 75 per cent, with its overall interest – including the protected assets – at 84 per cent.

Back in the real economy, unemployment, which had been bubbling along at a rate of around 5 per cent for the previous few years, had risen to 6 per cent in mid 2008, and up to 8 per cent or nearly 2.5 million a year later. The UK economy began to contract in the second quarter of 2008 and over the six quarters that followed shrank by 6.4 per cent in total, a far sharper contraction than in the recessions of 1990–91 (when the economy shrank by 2.5 per cent) or 1980–81 (when it shrank by 4.6 per cent).

Taken as a whole, these were dramatic times. The popular press was happy to portray the government as spending billions of taxpayers' money to bail out the greedy bankers and the public understandably felt betrayed and outraged at the suggestion that these people took huge rewards for effectively having broken the system. But was bankers' greed really the cause of the crisis and subsequent recession? In reality there were a number of contributory factors, some of which could have been avoided, as the next chapter describes.

2 What could have prevented it?

If the crime that has been committed is causing the worst financial crisis and recession in living memory, then the list of potential culprits is many and varied. Here are a few of them:

- *credit rating agencies*: for providing over-optimistic risk ratings on complex financial products, possibly because their client was the organisation issuing the security in question
- *consumers*: for borrowing what they could not afford
- *statistical economists*: for making over-simplistic assumptions when devising theoretical pricing models for complicated financial products, which had the effect of magic-ing away the underlying risk during the securitisation process
- *traders and/or bankers in general*:
 - for relying on these models without understanding them, and not worrying about their lack of understanding because they seemed to be making money; in the words of the US writer Upton Sinclair, ‘It is difficult to get a man to understand something when his salary depends upon him not understanding it’¹
 - for running excessively high debt–capital ratios, which enabled the crisis to become systemic, rather than isolated to a few institutions
 - for paying out high levels of remuneration rather than using that money to strengthen capital buffers
- *institutional investors*: for failing to change the behaviour of the boards of financial institutions and providing inadequate stewardship of such institutions, instead piling on the pressure for dividends and share buy-backs to boost their returns
- *non executive directors*: for failing to ask the right questions of executive directors

What could have prevented it?

- *regulators*: for allowing the problems described above, indeed in some cases approving risky decisions, and for failing to spot that the institutions they were regulating were taking on more risk than they could cope with
- *the Federal Reserve*: for not realising the implications that would result from the rise of subprime mortgages; in the words of the former Federal Reserve chairman, Alan Greenspan, in a US ‘60 minutes’ TV interview in September 2007, ‘I really didn’t get it until very late 2005 and 2006’²
- *the Clinton and Bush administrations*: for actively encouraging Fannie Mae and Freddie Mac to make subprime mortgages and, some have argued, repealing the 1933 Glass–Steagall Act, which separated retail from investment banking
- *China*: because the rapid growth of the Asian economies led to a savings exodus from East to West that drove down global interest rates and caused a thirst for higher yield products, which caused excessive risk-taking
- *irrational exuberance and/or fate*: because, as Keynes described it, bubbles always happen, from tulip mania to the dot-com boom; this time it was mortgage-backed securities
- *governments*: because they are supposed to be in charge of everything, and were afraid to kill the golden goose of tax revenue

All the above are implicated, although some to a greater extent than others. As discussed in chapter 4, however, the repeal of the Glass–Steagall Act in 1999 does not seem to have had a direct impact on the recent crisis, as most of the firms that faced difficulties were primarily retail or investment banks, not both. The structure of the business was not a predictor of resilience.

All the other suspects bear some responsibility. But to fully understand the implications for UK policy, as this pamphlet seeks to do, we need to start by understanding what happened in the USA, where the problems began.

Primary factor 1: US regulatory environment

It was far too easy to borrow money to buy a property in the USA. A deliberate loosening of the regulatory environment, coupled with low interest rates, and a celebration of the role of subprime markets to enable greater access to homeownership, proved an explosive cocktail, which caused around 20 per cent of all new mortgages to be subprime at the peak of the housing market in 2004–2006.³

The main causes were:

- a clear political decision by the Bush and Clinton administrations to ratchet up the affordable housing goals set by the government for Fannie Mae and Freddie Mac; this encouraged the agencies not only to purchase securities backed by subprime loans but to originate such loans as well; an international regulatory expert interviewed for this research stated that this was ‘against the explicit views of their internal risk operators’
- the Commodities Futures Modernisation Act 2000, which reduced supervision of financial commodities such as ‘interest rates, currency prices and stock indices’, enabling the rapid rise of credit default swaps in an unregulated fashion, which later led to the collapse of AIG as well as problems elsewhere
- a relaxation in 2004 by the Securities and Exchange Commission (SEC) of the ‘net capital rule’ for five investment banks – Bear Stearns, Lehmans, Goldman Sachs, Merrill Lynch and Morgan Stanley. Previously this had limited firms’ debt–capital ratios (leverage) to 12:1; once removed, firms were free to invest in a far greater volume of riskier assets, causing debt ratios to rise sharply, in the case of Bear Stearns to 33:1; by October 2008, the chairman of the SEC, Christopher Cox, was forced to concede what many would say was self-evident: ‘voluntary regulation does not work’⁴
- a general failure of the regulators to see the rise in systemic risk in the system; instead the lead of Alan Greenspan was followed, who as late as April 2005 gave a speech praising the role of computer-based risk models that used past credit scores rather than predictions of future incomes to decide whether loans should be made:

Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending; indeed, today subprime mortgages account for roughly 10 percent of the number of all mortgages outstanding, up from just 1 or 2 percent in the early 1990s.⁵

As profits rose, checks and balances seemed to become even more unfashionable. Online applications for mortgage loans became common, with some companies making a virtue of a product that required no documentation at all. Their online offering included products such as ‘no doc’ mortgages, which required no supporting documentation, not to mention ‘ninja’ (no income, no job, no assets) mortgages to people receiving benefits. In May 2006 the subprime lender Amerinquest decided to shut its 229 retail outlets and take all applications online.

Countrywide Financial, the largest US mortgage company, adopted a policy of automated underwriting and others followed suit; by 2007 an estimated 40 per cent of subprime loans had automated underwriting. While they may have been praised by Alan Greenspan, such systems were later criticised for placing disproportionate emphasis on the easily available previous credit ratings, rather than focusing on future income streams. Overall, it appeared that the constraining factor in granting a loan was not the individual’s ability to repay, but the company’s ability to securitise it.

On top of this, low interest rates allowed companies to offer teaser rates of interest on adjustable mortgages, to make them superficially attractive to investors. In some cases the repayments did not even cover the actual interest accruing, so the overall value of the debt continued to rise over time even when payments were being made.

With more finance available, house prices rose, and so existing homeowners felt flush, raising their mortgages and withdrawing equity to finance consumer spending. So when the US federal funds rate began to rise in 2004, the bubble burst and foreclosure rates rose sharply. The problem was that, in the

meantime, the mortgages that should never have been sold in the first place had been securitised and sold around the world.

Of course subprime and excessive lending were not exclusively an American phenomenon. In the UK the growth of the buy-to-let market in 2000–2007 and the easy availability of mortgages offering more than the value of the property were evidence that things were getting out of hand. However, this merely increased our vulnerability to the effects of the crisis, rather than causing the crisis itself: the transmission mechanism that led to the recession in the UK began in the USA rather than the domestic housing market.

In any case, the proportion of toxic assets held by financial institutions that were American in origin vastly outweighed those that originated in the UK, even after accounting for population size. The International Monetary Fund estimates that the value of US-originated toxic assets is around \$3.1 trillion, compared with \$900 billion in assets originating from Europe and Asia combined.⁶

A UK-based academic who is expert on comparative systems of regulation and brings considerable private sector experience emphasised the difference between bad loans made in the UK compared with those in the USA:

Most UK securitised mortgages are performing as it was expected they would through a cycle this severe, unlike in the US... in the US you can default on your home and they can't take your car. In the UK if you default, you lose everything, so incentives to keep paying are much higher in the UK.

This view was reinforced by a senior investment banker who also has public policy experience: ‘US mortgages have an additional “walkaway” risk – you can just leave your house and the bank can't get you, unlike in the UK.’

It follows that had there been greater control over the availability of credit in the USA, particularly that secured against property, the crisis could have been avoided.

Primary factor 2: management failure

Even given the existence of bad debt in the system, it takes a bad manager not to notice it. There is nothing intrinsic about being a financial services company that means it needs to expose itself to excessive risk.

The firms with difficulties were those whose boards did not understand the contents of asset-backed securities and their relationship to the underlying assets, or that creating a synthetic or derivative product does not take away the risk, and that taking risks off balance sheet does not make them go away. Stronger autocratic leadership – as was arguably the case in RBS and HBOS – rather than collective decision making led to weaker institutions.

One industry insider who had worked at RBS described it thus:

Securitisation was popular with the purchasing institution, which felt the risks had been spread to the point of making them negligible. Many of those models had been devised by PhD-level mathematicians but the risk functions within the banks could not understand them and assess them effectively.

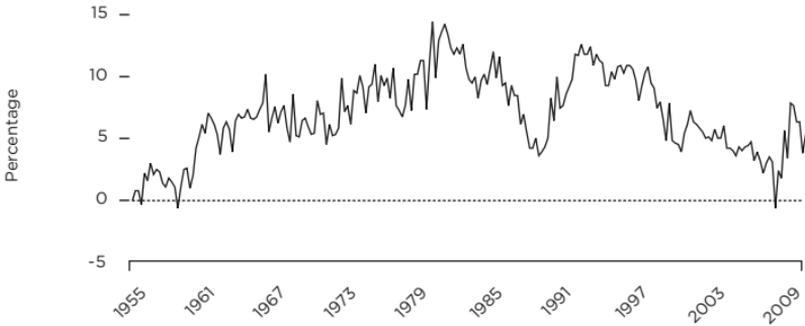
It follows from this that the problems caused by a lax regulatory environment in the USA could have been avoided by better management decisions on the part of some of the world's major financial institutions. We know this is possible because some companies' experience of the financial crisis was more extreme than others. So at the very least it is not the case that the bankers collectively caused the crisis. The better view is that too few bankers did enough to prevent it.

UK aggravating factor 1: private debt

Once the bad loans had been made and some bankers had bought them, problems were inevitable. But the severity of the impact of the crisis in the UK was due to a third factor: the high level of overall debt in the UK economy.

Up until 2007, the British consumer was feeling confident. Low inflation and low interest rates had caused house prices to rise, bestowing a feeling of affluence on much of the economy.

Figure 1 The UK household savings ratio



As a result, consumer spending rose, and with it levels of debt. Indeed by 2006 the savings ratio had fallen below 3 per cent, the lowest it had been at any time since the 1950s (figure 1).

Up until 2007 the official government response to this phenomenon was that, as in the 1950s, people were feeling good about life and this was a reflection of the success of economic policy, rather than something to be worried about in itself.

In mid 2008, oil and food prices rose, simultaneously pushing heating, petrol and shopping bills up. This happened at the same time that the banks started reining in credit; for a few months it was virtually impossible to come by a mortgage, at the same time that employees began to feel less secure at work. As we saw in the previous chapter, this led to a collapse in consumer confidence, causing a reining in of discretionary spending and instead a paying down of debt. This eventually contributed to a full-scale economic slowdown, exacerbated by the fact that companies too had been enjoying the easy availability of credit and so were reluctant to borrow further in the face of lower consumer demand to tide themselves over.

Had there been less consumer debt, this effect would have been less pronounced and the recession less severe.

UK aggravating factor 2: regulatory failure by the Financial Services Authority

It wasn't just consumers who lacked a financial safety cushion to shield them against adverse financial effects. Many financial institutions did as well. In order to have a licence to trade from the FSA, banks need to demonstrate they have sufficient capital to withstand unforeseen events. These limits are set by the FSA with a backstop provided by the Basel committee.

The failure of the FSA in the run-up to the crisis was two-fold. First, it exercised insufficient challenge to the institutions that had weak internal risk management: the bad bankers as described above. Second, it failed to ensure that banks had sufficient capital and liquidity to survive a sharp downturn in the housing market, leading to requirements to raise capital in the heat of the crisis.

To be fair to the FSA, these failings were recognised at an early stage. In 2008 it ran a number of stress tests on each of its regulated entities and advised on the level of capital required to be raised accordingly in order to bring stability to the system. At the end of 2007, UK banks had a core tier one capital ratio of 6 per cent; by mid 2009 this had risen to 7.7 per cent.⁷

Being forced to engage in frenzied capital raising in the heat of an economic and financial crisis is not, however, a situation a bank likes to find itself in. Investors are already nervous about the sector, increasing the risks of a failed rights issue, which could precipitate even more instability, not only in the share price of the company concerned, but in the financial system as a whole. And of course the price of the capital rises in troubled times. Moreover, some took the view that having to keep more capital in reserve was the last thing a firm needed when its balance sheet was already under huge pressure; the counter-cyclicality of the FSA's capital raising requirements was not popular.

The alternative of continuing with inadequate capital, however, would have been far worse. The banks that remained needed to demonstrate they had sufficient buffers against the next shock that might occur, in order to restore confidence in the system and make it less likely that that shock would ever happen.

These two aggravating factors – low savings in the UK plus insufficient capital held by UK banks – share many similarities. Even if British consumers had higher savings, and the banks had stronger reserves, the recession probably would not have been avoided but the impact of the recession and the instability in the markets would probably have been less severe.

Initial policy conclusions

It follows from the discussion so far that the regulatory authorities would be wise to:

- raise the capital requirements and liquidity reserves of banks to increase their resilience to a downturn and prevent riskier lending, preferably in a counter-cyclical way so that resilience increases with the risk of a crash increasing
- mandate more effective monitoring of risk within individual firms

So much is already well understood and in the process of being implemented through reforms to the Basel, SEC/Federal Reserve and EU regulatory systems. This pamphlet does not offer a commentary on that process.

We do, however, wish to draw out other UK-specific conclusions that follow from the events that we have seen. Specifically, the experience of the last few years suggests that we need a far clearer debate about the policy tools available to deal with asset price bubbles and high levels of consumer credit in an environment where retail inflation and interest rates are stable and low.

In Britain, before the Bank of England was granted independence, interest rates were seen as a tool for controlling house prices, albeit a blunt one. It is the right thing to have an independent Bank of England targeted on keeping retail inflation (excluding house prices) low, but it prompts the question of asking what policy tools are available when that target is achieved, but house prices are still rising rapidly.

There are two possible answers. The first is regulatory, namely implementing specific loan-to-value ratios for lending

into the housing market, which have the capability of being tightened in a counter-cyclical fashion as house prices rise in order to curb the bubble. In Hong Kong, for example, the government has implemented a system of loan-to-value caps in residential mortgage lending in order to curb short-term property speculation and reduce the risk of asset bubbles forming. The caps are linked to property value, so the maximum permitted loan-to-value ratio is lower on high value properties. For example, on residential properties worth over US\$1.5 million, the loan-to-value cap is 50 per cent. The new financial stability committee of the Bank of England is therefore right to put loan-to-value ratios firmly in its purview.

The second is fiscal, namely to have the ability to raise property taxes when house prices rise (and potentially lower them when confidence is low). This is a matter for government, not regulators. Successive UK governments have already conceded the principle of using stamp duty as a proactive policy lever. In 1997 a new higher rate of stamp duty of 2 per cent for properties over £500,000 was introduced and then raised to 4 per cent by 2000 as the market boomed. Conversely, the minimum threshold for stamp duty was raised from £125,000 to £175,000 in 2008, in an attempt to restore some confidence to the market during the worst of the credit crunch. Around 2,000 poorer areas in the UK have for some years had a higher threshold, in an attempt to boost activity. And a brief attempt was also made in 2010 to introduce a 'first time buyer' stamp duty exemption.

The UK government should use this tool more aggressively, giving an explicit commitment to use stamp duty as a counter-cyclical tool for dampening a house price boom. Again, Hong Kong provides an example of how such a policy might operate in practice. In November 2010, Hong Kong introduced a special stamp duty of 15 per cent on housing transactions conducted within six months of the owner buying the property, 10 per cent on transactions taking place between 6 and 12 months and 5 per cent on those taking place between one and two years.

Another possibility would be to introduce capital gains tax on primary residences. Like raising stamp duty, this would be

simple to implement – it is already done on secondary residences – and there is a strong argument that it is a fair way to raise revenue because it taxes unearned wealth. It is also relatively simple to raise or lower the rate, although it would be important to align any changes with the inheritance tax system to prevent distortions. Having to pay capital gains tax when a house is sold would reduce the so-called wealth effect from rising property prices, whereby consumers run down their cash savings because they (erroneously in this case) believe they are better off, and so can afford to spend more, because the value of their house is rising.

A key advantage of using fiscal rather than regulatory measures to deal with a housing boom is that fiscal measures would boost the national coffers when house prices begin to rise, which would give the government greater resources to spend its way out of any ensuing slowdown in the economy. Unfortunately, it may be harder to achieve political consensus for such changes. In practice both regulatory measures and fiscal measures should be properly debated now, to establish the approach the UK will adopt when the next phase of house price rises begins.

Recommendation 1: The UK government should stand ready to use fiscal tools to take the shine off asset price bubbles, in particular by varying stamp duty to a far greater extent and introducing – and varying – capital gains tax on primary residences depending on the direction the housing market is taking.

In the UK we also need to be more alert to the increased vulnerability of consumers to external shocks if the savings ratio – the proportion of income that is saved rather than spent – is low. Just as the banks should be required to hold more capital to insulate themselves from the effects of a financial crisis or recession, so it should be a matter of policy that a low cash savings ratio should provide an early warning signal to government and regulators that consumers are not adequately protected.

Again, rather than waiting for the next asset bubble to inflate, now is the time for a policy debate on the relevance of the

savings ratio as an indicator of excessive consumer vulnerability in the economy. It would be useful to establish a consensus now of the trigger value at which the savings ratio should be viewed as dangerously low, so as to increase pressure on government and regulators to take action when that level is reached. In addition to the fiscal and regulatory measures discussed above to curb over-exuberance in the housing market, it would also be useful to discuss options such as increasing incentives to save via particular products, curbing consumer credit in other areas than housing, or simply issuing a general warning to unsettle markets a little. None of these actions would be attractive to a government faced with a crisis, so it is vital to discuss and agree them in advance.

Recommendation 2: The government should set a reference rate for the savings ratio and issue a warning designed to unsettle the markets if it is breached in the early stages of a boom.

While it is – relatively – simple to constrain excessive leverage in the banking sector, it is harder to prevent the second direct cause of the crisis: management failure in some institutions. The actions of regulators to put an increased focus on risk management, scenario planning and stress testing within financial institutions will help.

But it is also the case that chief executives are accountable to boards and so issues of corporate governance should remain under constant review. In the UK, the Walker review of corporate governance, published in November 2009, made useful recommendations on training and support for non-executive directors, including their expected time commitment, and emphasised the importance of risk management;⁸ at the EU level the European Commission has recently concluded its own consultation on measures that can be taken to improve corporate governance in financial institutions.⁹

The challenge is to have serious non-executive financial expertise and experience around the boardroom table of people who have a mindset to challenge constructively the accounting

orthodoxies and culture of the firm in question. However, individuals with the necessary experience could well have a conflict of interest (for example, as a result of working for a competitor firm) or be so ingrained in the sector that they may find it hard to deviate from the industry's groupthink. The standard solution is to go for a box-ticking diversity candidate as a non-executive, but if they are perceived as such by other board members then they will have an uphill task in establishing the necessary credibility. This is not a new problem, and it does not exclusively apply to the financial services sector.

During the interviews and consultation for this research, two clear views emerged: first, the most important quality of a non-executive director was the attitude and personality of the individual, who needed to be a team player, yet tenacious in exploring where improvements could be made; second, being a non-executive can be a lonely job, particularly if your instincts take you against the grain of an organisation and you have less information than executive members. Our recommendations are designed to address both these failings.

Recommendation 3: The UK government should work with industry to establish a board-level careers service across different sectors where senior individuals, entrepreneurs and leaders from all walks of life can self-refer to receive assessment, experience, advice and training to make them credible candidates for board positions in future.

Recommendation 4: Within the financial services sector, the Bank of England as part of its new role to monitor systemic risk should provide an informal and confidential mentoring system for non-executive directors, particularly those from outside the sector, giving them a safe place to test hypotheses and seek analysis and advice.

3 An important distraction: the so-called need to rebalance

The argument in the previous chapter is that the main causes of the financial crisis were the lax regulatory environment in the US mortgage markets, which caused a large number of bad loans to be made, the nature of the financial markets which allowed this risk to be spread around the world, and management failure in some global financial institutions.

The UK economy was particularly vulnerable to the loss of consumer confidence that resulted from the banking crisis because of our historic low levels of savings. The situation was not helped by regulatory failings that did not spot the crisis. Some policy conclusions that flow directly from these observations have already been outlined.

Now is the time to address directly the regrettable fact that the public debate on the banks has been following an entirely different chain of logic. We hear repeatedly from politicians on left and right the argument that the recession was caused by us somehow being ‘over-dependent’ on financial services and therefore peculiarly vulnerable to financial crises, so it is desirable to rebalance the economy so that a smaller proportion of our national wealth is created from the financial services sector – perhaps in favour of manufacturing – to make our economy more robust in the future.

This is a poor argument, for a number of reasons.

For a start, the financial services sector is not the largest sector in the UK economy. At its peak it was around 10 per cent of GDP, less than manufacturing (around 14 per cent). It is therefore illogical to argue that there is an over-dependence on the former that requires a rebalancing in favour of the latter.

Second, those advanced economies that had a proportionally smaller financial services sector did not have a shallower recession, so it does not follow that having a relatively

large financial services sector makes a country more vulnerable. Table 1 shows that there is no obvious connection between the size of a country's financial services sector as a percentage of GDP and the contraction of its economy in the recent crisis.¹⁰ Germany and Japan generate proportionally less of their GDP from financial services than the UK but their economies contracted more than the UK economy. The percentage of GDP attributable to the US financial services sector is nearly as high as in the UK, but the US recession was mild in comparison with the UK recession.

Table 1 **Change in real GDP during 2008-09 recession and financial services share of GDP in seven countries**

Country/region	Change in real GDP in 2008-09 recession (%) ¹¹	Financial services share of GDP (%) ¹²
Canada	3.1	Unknown
France	3.2	4.6
Germany	6.3	3.8
Italy	6.5	Unknown
Japan	8.0	6.7
United Kingdom	5.9	8.3
United States	3.5	7.5

Perhaps it would be more useful to consider why problems in the financial services sector can become so damaging to the wider economy. The answer lies in the broad utility nature of financial services – all consumers and firms rely on the services

they provide. (A similar argument can be made for the oil and gas industry.) This does not mean we are ‘over-dependent’ on financial services, rather that the potential risks to the wider public interest from malfunctioning of the financial services sector justifies public action to reduce these risks.

Underlying the argument that we need to rebalance financial services lies a deeper concern that the financial service sector somehow has served to crowd out more sustainable or ‘socially useful’ activities in the so-called ‘real’ economy of industry and commerce. The theory goes that capital has been channelled inefficiently over time, away from these sectors towards wholesale markets and property investments, pursuing short-term returns over longer-term value creation.

This is a valid concern, which deserves serious exploration by UK policy makers. Our obsession with home ownership and property prices in this country is not necessarily in our long-term interest. Would a curb on the amount that can be lent in this sector lead to a corresponding rise in lending to industry and consequently to more innovation and economic growth? That is not clear – capital may instead seek greater returns abroad. Should government set up a state investment bank to channel greater investment into industry? It could, as long as it is clear that the taxpayer bears the risk that the market will not carry. Better to create the conditions that support value creation, which include an environment where high skill, high value added, intellectual-property-based entrepreneurial activity that is valuable can find a way to grow regardless of the sector it is in, even if it includes the financial services sector.

As a starting point, the Bank of England’s policy of quantitative easing should not simply seek to purchase government bonds on the secondary markets but corporate securities as well. When the policy was introduced in 2009, this was explicitly stated as an aim; in practice the number of corporate as opposed to government securities that have been purchased is very low. Purchasing corporate bonds would not help risky intellectual-property-based start-ups, but it would at least have a positive effect in the real economy by lowering the cost of capital for large corporates seeking to invest and expand. And it would send

a signal that growth was something the Bank thought was a relevant consideration, particularly as the new Basel rules make it harder for banks to meet their capital requirements by holding such debt. The problem is that if the Treasury directed the Bank to purchase corporate bonds there might be issues with state aid; the Bank needs to decide to do it for itself.

Recommendation 5: In future rounds of quantitative easing, the Bank should purchase more corporate securities and correspondingly fewer gilts.

Of course it is possible to rebalance away from financial services to manufacturing without in any way constraining the ability of financial services to grow beyond its normal sustainable rate; manufacturing would simply have to grow faster. However, to pursue rebalancing in any other way would not be in our national interest, not just for the reasons explained above, but also simply because it is a lucrative source of economic activity where Britain retains a comparative advantage. A strong case for the City needs to be made, and it is to this subject that we now turn.

The progressive case for the City

Data published by TheCityUK shows that the financial services sector employs around a million people in the UK, of whom around a third work in ‘City-type’ jobs in the square mile and Canary Wharf.¹³ In addition there is important indirect employment, for example an increasing demand for professional services from accountants and lawyers, who tend to cluster around professional services. The Wigley report for the Chancellor put the total employment figures even higher. It stated:

*Financial services employs some 1.3 million people in the UK – 500,000 of them in London... in addition to this direct employment, it has been estimated that the expenditure of London’s financial services employees directly supports a further 400,000 to 500,000 jobs in the UK economy.*¹⁴

The total tax contribution¹⁵ of the financial services sector in the financial year to 31 March 2010 has been estimated at £53.4 billion in a report commissioned by the City of London from PricewaterhouseCoopers.¹⁶ This equates to 11.2 per cent of total government receipts from all taxes. Each person employed in the financial services sector pays an average of £25,000 in tax. For every pound granted in bonuses, 50p goes to the government, and a further 20p in VAT if the remainder is spent. There are several hundred banks in London, only a handful of which are high street names. Yet the rest are paying tax to the UK government. In the words of one foreign-owned investment banker, ‘The UK has the fiscal benefit of the foreign banks without knowing how to deal with them.’

The UK runs a surplus in financial services in its balance of trade; the Pink Book, which publishes details on the UK balance of payments, showed a trade surplus that peaked at £46 billion at its peak in 2008, falling back to around £40 billion the subsequent year, although TheCityUK considers that this might actually be an underestimate.¹⁷

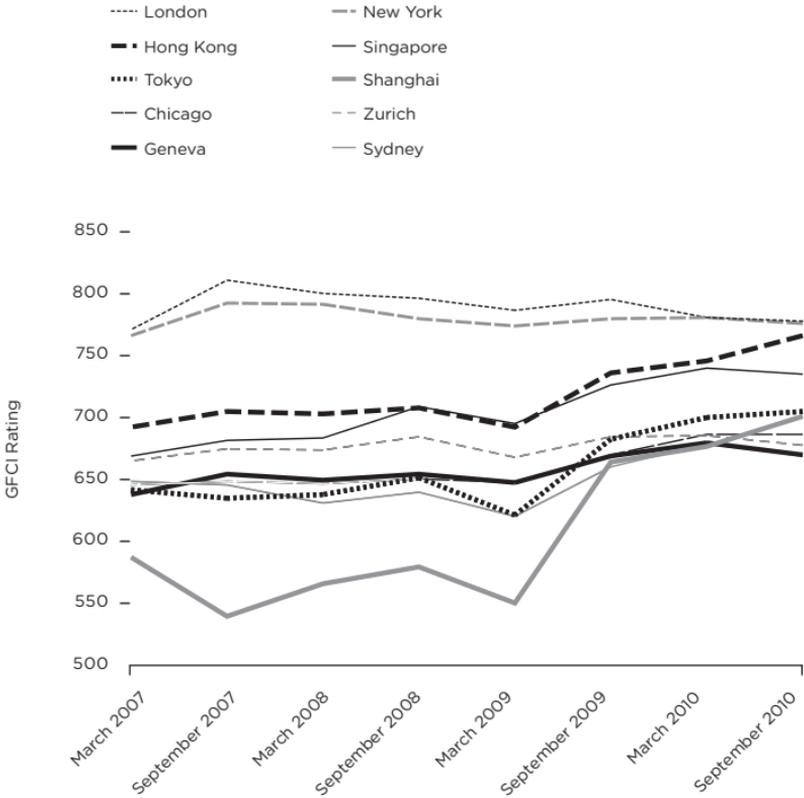
Finally, although necessarily based on subjective measures, London still ranks top of the global competitiveness index for financial services. In an increasingly competitive world, does it make economic sense to try to constrain a sector that is yielding significant revenues, employing large numbers of people, helping to counterbalance the persistent current account deficit in manufacturing and in which we appear to be a global leader?

The evidence points to the opposite: as long as we can ensure that the activity of the financial services sector is regulated in ways that minimise the impact and frequency of economic shocks affecting the wider economy, perhaps it is better to promote it, rather than to try to weaken it.

The sector that cried wolf

The banking sector has always possessed an effective lobbying voice, adept at threatening to withdraw from Britain if it does not get its way in the public policy debate. But with politicians now appearing anxious to align themselves with the public anger

Figure 2 The Global Financial Centres Index



against the sector, it is time for a proper analysis of whether it matters if there is a drift away from the UK by high finance.

First, let us look at the extent of the threat. The Global Financial Centres Index (GFCI) has been published twice yearly since March 2007. Over that time it shows London at the top, but most recently the lead over New York has eroded and Hong Kong has now risen to within spitting distance. Indeed, the principal Asian financial centres have all improved their competitiveness substantially in the last few years, with Shanghai

being the fastest new entrant, dislodging Frankfurt from the top ten. Figure 2 shows the full picture.

The threat to the UK's position therefore seems real. Two questions follow: why has this happened, and does it matter?

Why are we losing competitiveness?

The GFCI is compiled from two separate sources of data:

- external objective indicators (grouped around people, business environment, infrastructure, market access and general competitiveness)
- interviews with nearly 2,000 financial services professionals

Interviewees rate taxation and regulation as the most important factors in competitiveness.¹⁸ The stagnation of London's GFCI rating in comparison with the marked increase in that of the principal Asian centres suggests that London should pay close attention to the critical areas of taxation and regulation.

The interviews conducted with senior practitioners during the course of the research for this pamphlet support this view. But they have also showed that it is taxation, rather than regulation, that is having the greatest negative effect.

In the words of one global executive, currently based in London:

The 15 per cent income tax rate available in Hong Kong is looking increasingly attractive.

Another said:

Rumours abound of the Swiss authorities ringing people up on the phone and actively offering to negotiate a more advantageous rate of personal taxation.

A third, who had served on the taskforce for the 2009 report on global competitiveness commissioned by Alistair Darling,¹⁹ commented:

The evidence we have is that stability and predictability of taxes are as important as the level.

And a leading policy analyst for a London-based industry trade association reflected what many were telling us when he said:

The 50p tax rate was a policy discontinuity that has raised the political risk for the banks hugely. People are just frightened as to what might come next.

Another, who has 15 years' experience in government as well as in the banking and insurance sectors said:

The decision of the previous government to raise the higher rate tax twice in two years (initially to 45 per cent and then 50 per cent) in contravention of a manifesto promise caused a fundamental breach of trust with many FS executives who are now less inclined to believe political promises on tax within the UK.

A senior practitioner in a major investment bank talks of non-British traders who work across Europe now choosing to move away from London because the environment – the levels of taxation and bankers' position in society – is no longer seen as attractive, with the result that their trades are no longer booked in the UK. Thus the British exchequer loses not only income tax, but also corporation tax from the profit on the deal itself. The *Financial Times* has estimated that Britain will lose £500 million annually as a result of tax-driven migrations of hedge fund managers and employees. The departure of two leading managers (Alan Howard, founder of Brevan Howard, Europe's biggest hedge fund, and Mike Platt, founder of BlueCrest Capital, the third biggest) will cost the Revenue £200 million, according to a *Financial Times* analysis of their funds' accounts.²⁰

It is important to recognise, however, that the migration of hedge fund managers and employees has been described by a financial consultant who advises on tax migrations as 'not a

flood yet – it’s a trickle’.²¹ A recent press report also noted that ‘the fears of an exodus of bankers have yet to materialise.’²²

Nonetheless, the lowering of bankers’ position in society and increases in personal taxation, as described above, have served to depress morale, and while this may not yet have led to a mass outflow of institutions or professionals, they are likely to have an effect at the margins. At the very least these developments have the potential to dampen the rate at which London will grow in the future, which will reduce future taxation revenues and employment.

In the words of a senior executive in a high street retail bank:

You won’t know for definite what the effect is until the damage has been done. The question is, do you want to take that risk? Politicians and political pundits are in denial – they need to decide what they want... and be aware that their decisions are being made in an environment where there is already huge competitive pressure away from London.

Overall there is little doubt that the recent hikes in personal taxation, combined with the rhetoric of banker bashing from government and media, has done some damage to the perception of senior financial services executives that London is a key place to locate. What has emerged from this research is that the perceived lowering of the social status of financial services and the UK’s increases to the already relatively high marginal tax rates have had a far greater effect on the minds of senior executives than any talk of higher capital controls or greater levels of financial regulation in general.

Recommendation 6: Politicians who want to appear tough on the banks but not weaken the sector should restrict their comments to strengthening banks as institutions, rather than weakening bankers as individuals.

Does it matter?

If we presume that there has been some attrition at the edges in wholesale financial services, we need to ask whether this matters

to the real economy. Putting aside for one moment the loss of tax revenue and some professional job opportunities, would it make a difference outside the square mile and Canary Wharf if we lose our competitiveness?

Of course the reach of the financial services sector goes far wider than London. Witness the alarm and despair felt in Leeds, Bradford and Newcastle when the problems at HBOS, Bradford & Bingley and Northern Rock surfaced. In my former constituency of Burnley, back office functions for several building societies sustain several hundred jobs in one of the lowest wage areas in the country.

But of course these retail jobs would still exist if we didn't have a globally renowned wholesale financial services sector. Yet many of the hundreds and thousands of people employed in this part of banking and insurance still feel a sense of hurt pride when they read the anti-banking headlines, combined with a feeling of injustice when they consider how much their superiors have been paid, certainly if the sessions held with union representatives as part of the research for this pamphlet are anything to go by:

I'm working harder and harder talking to customers all day, getting paid £14,000 per year, when the people who run our company are paying themselves a fortune for messing it all up.

Retail bank worker, South East of England

More interesting is to examine the effect on the wider UK economy if we did not have a global financial centre on our doorstep.

If a medium-sized manufacturing firm outside London was seeking to hedge a contract, or finance a take-over, would this be more expensive if the wholesale markets in London did not exist? The anecdotal evidence that we have indicates that there is an effect. It would still be possible to do the trade – their routine bankers would be able to arrange it for them, but the price could well be higher if there were not highly liquid wholesale markets in the same country speaking the same language in the same time zone.

We heard the following views:

The firm would just get better advice because the City of London is there on the doorstep.

Senior investment banker

In open, efficient, global markets, this should make no difference, however the fact of the matter is that smaller companies will be better covered here, because the banks are here. If the banks were all in France, small French companies would be better covered.

Senior expert in international regulation

If the HQ moved to Asia, the top brains would leave, which would send a powerful signal to the rest of the organisation that the way to attract the attention of the senior managers would be to move too. It'd create a brain drain because the second or third layer of people would want to go too.

Very senior manager, international investment bank

In another interview it was pointed out that having large international banks in the City made it more likely for back office functions to be located elsewhere in the UK. For example, the US investment bank Citi has recently opened a supporting facility in Belfast; JP Morgan has a centre in Bournemouth; and Deutsche Bank has part of its operations in Birmingham.

Overall it would remain useful to be able to quantify this effect and in particular whether there is a link between a lower price of credit available to UK plc and the depth of capital markets in London. The Banking Commission makes a passing reference to the relationship between the structure of the industry and the rest of the economy, but this subject requires further examination. Nevertheless, there is certainly some evidence that over time having a strong banking sector boosts the so-called 'real economy' rather than detracting from it.

Recommendation 7: It is in the national interest to have a strong financial services sector in Britain, as it provides taxation revenue and has direct and indirect economic effects. The government needs to be brave and recognise

An important distraction

this. It should set out a clear policy direction to support investment in financial services in Britain, designed to capitalise on strengths and address weaknesses.

4 Market rates, market failure and moral hazard

So far this pamphlet has discussed the causes of the financial crisis, and concluded that regulatory intervention is justified in order to reduce the risk of systemic instability happening again. The particular vulnerabilities of the UK have also been examined, leading to conclusions that greater policy intervention is required to deal with situations when asset prices are high and the savings ratio is low. Arguments that Britain should, as a point of principle, seek to weaken its financial services sector have been dismissed; the sector is an important source of jobs and revenue, and having it on our shores may well also contribute to lower costs of capital for other parts of the economy.

Taking all this together, a general conclusion could be drawn that, provided that appropriate boundaries are set to protect the public interest, the operation of a fairly free market in financial services is a good thing for Britain. This chapter delves more deeply into some of the competition issues that have come to the fore as a result of our experience of recent years. It looks particularly at the issue of pay and bonuses; the fear that there will be no incentive to succeed if banks are seen as too big to fail (so-called ‘moral hazard’ arguments); and finally discusses some of the issues relating to the structure of the sector as a whole.

Pay and bonuses

If it is wrong to conclude that we are ‘over-dependent’ on financial services, it is also wrong to conclude from this crisis alone that permanent mechanisms should be put in place to prevent bankers from being paid so much. The greatest sense of public injustice arose from the suggestion that bankers were *paid for failure* in the run-up to the crash; it is important therefore not to conclude that *all* high levels of pay are wrong. Indeed, it can

logically be argued that the pay in those institutions that were less risky and able to withstand the economic storm was particularly justified.

Although this point has often been lost in the fracas over bankers' pay, in management theory at least there is nothing wrong with an organisation deciding to pay an individual a particular amount to do a defined job, or having an element of performance-related pay or bonuses when particular targets are achieved, providing they pay income tax like everyone else. In economic terms, problems arise when any of the following happen:

- The individual's incentives are misaligned with the company's objectives, leading to decisions being taken that are not in the company's interests, for example, if the individual is being rewarded for short-term profits and/or share price increases that may not bear any relevance to the company's long-term future.
- The remuneration feels arbitrary and/or its level is determined retrospectively, as can be the case with discretionary bonuses particularly at middle-ranking levels. Again, this can lead to misaligned incentives with disproportionate emphasis on short-term deals and the strength of relationships within the office. The confidential and non-contractual nature of such pay can also lead to discriminatory awards being used to send signals to staff as a proxy for proper management and HR processes. This also acts against the interests of the company because it is rewarding things that are irrelevant to the company's long-term interests.
- Remuneration policies promote an aggressive, macho culture, which reduces checks and balances to excessive risk-taking.

To avoid these dangers, among others, it is right for supervisory authorities to consider pay and bonuses as a legitimate part of their purview. Companies that incentivise short-term gain over long-term success are likely to have cultures that celebrate excessive risk-taking. This is unlikely to be in our overall economic interest.

In this context, it is worth noting that the FSA unveiled its revised remuneration code in December 2010. The code

implements guidelines circulated by the Committee of European Banking Supervisors. The effect of the code will be to cap cash bonuses at as little as 20 per cent of the total award, with the rest paid out in deferred share awards, which can be cashed in only after several years. This follows the established private sector practice of having long-term share plans linked to performance. So-called 'guaranteed bonuses' are banned, subject to a few very limited exceptions.²³

The missing piece in the jigsaw is having this performance-related pay linked and seen to be linked to clear outcomes. As well as ensuring compliance with the requirements of the remuneration code, companies would do well not to shirk from this issue and make sure that they can justify all of their pay awards. The new regulatory code requires banks to develop a comprehensive remuneration framework setting out how pay is aligned with risk. We suggest pay should also be aligned with the achievement of long-term business outcomes. Transparency is key, to ensure that shareholder and management objectives are aligned, and can be seen to be aligned, up and down the organisation. For that reason we support greater disclosure of pay both at and below board level, as indeed the Walker review on corporate governance also suggested. This is opposed by the banks, no doubt partly because they fear the public backlash that could follow from individual disclosures. However, sensible organisations will soon discover that if they publish the achievement of targets alongside pay, it will soon enough ensure that people are not paid for a job they have not done.

The aim should always be to attempt to link the long-term corporate strategy to individual time-limited objectives, which in turn are linked to pay, be it base pay or performance-related. The objectives may not be entirely financial and could, for example, include measures of customer satisfaction or fulfilment of long-term investment plans. Executives should be able to show how remuneration and bonuses are tied to the achievement of long-term objectives, rather than short-term financial results. Shareholders should be invited to scrutinise these longer-term objectives and the debate should be about the strategic positioning of the firm and its business plan rather than quarterly results. This

would encourage an even greater focus on medium and long-term value creation on the part of investors and management. And it would end any discrimination in bonus payments at a stroke.

Changes along these lines are in the interests of the owners of the company. They would not require legislation. Rather they should be championed by institutional investors, in so far as they are engaged, and by non-executive directors as a tool to obtain better performance from the board. If executives are told they will achieve a financial reward for the achievement of a predetermined target, then there should be no public anger if they receive that reward after they have achieved the target. The City will react that this would place London at a competitive disadvantage. But since all that is really happening is ensuring that systems are being put in place to align incentives within an organisation, and ensure that nobody is rewarded for failure, it would be a hard case to make.

These are issues for the private sector. But the government can have a role in designing a system that helps change behaviour and align the public interest with the interests of the board. This recommendation is designed to do that.

Recommendation 8: The government should raise a higher level of tax on discretionary bonuses (as opposed to other forms of performance-related pay) above a certain value that are not linked to contracted medium-term outcomes.

The implementation of such a recommendation would require some thought and compliance costs, but these would be more than recouped by the income realised.

Barriers to entry

This recommendation does not fully address the issue of fairness in the economy. There is no denying the fact that for many the high salaries paid in the financial services sector is a source of public discomfort. Remember that the average amount paid in tax annually by someone working in a City-type job (approximately £25,000²⁴) is not far off the average gross annual

pay for the country as a whole. Ask someone in the City and they will justify this by saying it is the ‘market rate’ for the job. In a sense this is clearly true, given that an individual can shift between competitor companies to obtain similar if not better rates of pay. But it still begs the question as to why the market rate is so high.

During the course of our research, a large number of different explanations were given for this, such as:

- *The nature of the industry*: because the balance sheets of banks are so large, and the return on equity so great, banks can sustain high salaries even though the proportion of profit that goes on pay is normal.
- *Lack of competition in the sector*: it could be that there are monopoly rents being enjoyed in the banking sector that inflate profits and so permit higher levels of wages to be paid.
- *Compensation*: individuals who are being paid such high salaries are in effect ‘owned’ by the bank, and the salaries are a compensation for loss of work–life balance. In the words of one insider:

They can tell you how many hours a day to work, when to get on a plane, to move your wedding or honeymoon (I know – I’ve been there), to be away from home for weeks at a time, to never see your family, to be on call 24/7, and they can fire you just as fast.

- *Personal value*: the level of skills and experience of individuals, including their personal relationships with clients, makes them worth a huge amount to the institution.

However, there is another argument that has not been considered: there is a competition issue in the labour market for professional services, of which City-type jobs are part. Put simply, as the price of something rises when it is in high demand and short supply, why is it that senior bankers are in sufficiently short supply that they command such high salaries? What is it that prevents the price being competed down?

Perhaps, as one of our interviewees said:

It is in the interest of currently employed bankers to limit the number of 'acceptably qualified entrants' so as to maintain salary levels. There is an argument that there is a huge cartel effect going on.

This may or may not be true; the problem is that we have no mechanism for considering it, because our existing competition policy institutions are not able to consider labour market issues, restricting their investigations to the, albeit very important, issues around product markets in the interests of consumers.

Take for example the recent investigation by the Office of Fair Trading (OFT) into the high fees charged for equity underwriting services.²⁵ The OFT pointed out that the fees for equity underwriting are high and identified a number of ways in which companies could informally improve competitive pressure. But nowhere is there any discussion of whether there are barriers to entry to become an equity underwriter and compete these fees down from a supply angle, because it is not in the OFT's remit to do so.

We therefore recommend that the government uses the opportunity of the proposed merger of the OFT and the Competition Commission to expand the remit of the competition authorities to include labour market failures.

Recommendation 9: The proposed new competition authority should have its mandate extended to consider labour market failure, with a primary focus on access to highly paid professions.

Moral hazard: too big to fail

A basic tenet of economics was ringing loud in the ears of the Governor of the Bank of England, Mervyn King, when he considered to what extent the Bank should provide a line of credit to Northern Rock when it faced difficulties in the wholesale markets over the summer of 2007. His argument was that if banks knew that government support was available, they would take greater risks and it would be more likely that they

would have to ask for help. His delay was one of the contributory factors leading to the run on the bank that occurred in September of that year.

The same argument has been running through the discourse in the years that have followed. Are certain banks ‘too big to fail’ – and if they are, does that not make it inevitable that their management teams will become complacent about risk, knowing that the government will have to step in when times are bad?

A simple analysis of what happens to senior executives when their banks get into serious difficulties should show that, notwithstanding the various bail-outs, there remain serious disincentives to executive complacency. Running a bank that gets into such difficulties that it has to be bailed out by the government is not a good thing to have on your CV. None of the chief executives or board members whose banks were nationalised or part nationalised are currently in post.

An alternative argument can be made that this is irrelevant since they had already made so much money, and built up such a large pension pot, that they didn’t need to work. Nevertheless the stigma associated with being seen to have caused a bank to fail remains a significant disincentive. While a bank may survive a government bail-out, that is only because a judgement is made that it is in consumer and/or national interest to do so; there is never any doubt in anyone’s mind that a failure of leadership has taken place.

It is unlikely, therefore, that moral hazard exists to a great extent among senior executives. Nobody wants to be in charge of a bank that has to go cap in hand to the government. And investors bear even greater risk. At the moment of rescue, shareholder value tends to be low, if not nonexistent. And in troubled times shareholders rightly take a hit: their holdings are diluted by rights issuances. As a matter of course, all equity in the event of failure – defined as a bank having to enter a so-called special resolution regime – should be wiped out; this didn’t universally happen in the heat of the banking crisis, which was a mistake. The position of debt holders should be clarified: their claim should be converted to equity with an appropriately

large discount. If this is legally clarified in advance it will of itself reduce the risk of failure; a wider group of stakeholders would have an interest in ensuring that this last resort is not reached and the taxpayers would be protected to a greater degree. The regulatory alternative – of putting the bad debt in a bad bank that is allowed to sink – should be perceived as less attractive to bondholders.

For the same reason it is important that any restitution fund such as the Financial Services Compensation Scheme should not accrue significant capital in advance (and the UK should oppose any such notions coming from Europe). Notwithstanding the undesirable temptation this may create for future politicians to spend the money, it could also lead to a form of moral hazard on the part of financial institutions. If a bank feels that it has already paid upfront into a fund that will help out a fellow bank that is now experiencing difficulties, it will have less incentive to help out at the time of crisis. Far better that firms should feel a common incentive to help, partly to avoid systemic failure, but partly because the failure of one could lead to much higher levies to a resolution fund to be paid by remaining firms further down the line, when the bills of sorting it out come to be paid.

Individual firms' living wills should also set out clear ways in which public and business would be able to continue their routine transactions in the event of a bank being perceived by the regulators as being in serious difficulties; upfront arrangements would of themselves reduce the risk of panic and so the likelihood of a run on the bank, which could make matters worse. Ideally, living wills should aim to keep the bank alive, not simply set out a procedure for the orderly resolution of contracts in the event of failure.

Recommendation 10: In the event of failure, those owning a bank should find their holdings are worthless; debt holders should be converted to equity, any restitution fund should not accrue huge surpluses, and living wills should seek to protect consumer interests not only in the event of failure but at the onset of difficulties.

Break them up?

Another potential solution to the fear that banks have become too big to fail is simply to break them up. However, this argument is based on a number of serious misconceptions.

Splitting retail from retail

There are two arguments advanced for breaking up the retail banks in Britain. The first is that smaller banks are less of a problem to resolve if they go under. This is true. The USA, for example, has a large number of small institutions. Bank failures at this level are common and the consumer compensation scheme is able to cope with them, albeit at high cost to the individuals involved. However, there is a problem with this approach, namely that small institutions are often weaker. They are unable to diversify and lack efficiencies of scale. They may suffer a lack of local competitive pressure, which makes them inefficient and vulnerable to an external shock. Indeed the US Federal Deposit Insurance Corporation has estimated that 300 community banks went to the wall in the recent crisis, with a further 800 on high alert.

The UK experience bears this out: the fall-out from the financial crisis saw the demise of Bradford & Bingley and Dunfermline Building Society and a number of smaller institutions as well as Northern Rock. Breaking up the retail banks would also have the potential downside of lessening competition on the high street from the reintroduction of local monopolies and a loss of efficiencies of scale, leading to higher interest rates and charges, not to mention the disruption to management teams at a time when they are attempting to rebuild balance sheets.

The second argument advanced in this area is that at some point it is important to consider whether there is sufficient competition in the retail banking sector. There is a perception that there is over-concentration in the sector, not helped by the deliberate suspension of competition law in order to facilitate the shot-gun marriage between Lloyds and HBOS at the height of the financial crisis. We certainly need to have a view on this, not least because at some time it will be right for the taxpayer to

recoup its investment in Northern Rock, Lloyds Banking Group and RBS, and so we will need to decide the best way to sell these stakes back into the market.

The Independent Banking Commission is looking at these issues, but this argument about competition in the sector may not be as simple as it first appears. First, by some measures the UK market is no more concentrated than that in comparable countries. Research by the International Monetary Fund shows that in the UK five banks own 65 per cent of assets, the same as Germany and Canada, but more than Australia where the equivalent number is three, and France, where it is two. Even in the USA, which is normally touted as the country that has a far less concentrated sector because of its high number of small organisations, a mere six banks own 65 per cent of banking assets.²⁶

The Herfindahl index is used as a formal measure of levels of banking concentration; a value below 1,000 is thought to indicate a low concentration, and one above 1,800 a high concentration. Research by the European Central Bank shows that the UK value on the Herfindahl index was 467 in 2009, lower than the EU16 average of 663 (or 632 for the EU27).²⁷

Second, the merger between Lloyds TSB and HBOS has already been considered by the competition authorities. Under state aid rules, the European Commission has required Lloyds Banking Group to divest 600 branches, equivalent to 4.6 per cent of the personal current account market.²⁸ This lessens the urgency of a full scale competition inquiry by the UK authorities, although the issue should be kept under review, not least because the Office of Fair Trading in October 2008 identified that there was a 'realistic prospect' that the merger would result in a 'substantial lessening of competition' in relation to personal current accounts and mortgages, and services for small and medium-sized enterprises in Scotland. Since then, however, the work of the OFT has focused on the reluctance with which consumers switch current accounts, not because of a dearth of suppliers but because of the hassle factor involved.²⁹

Recommendation 11: There is no immediate case for splitting up big UK retail banks.

Splitting investment from retail

Much has been made of the argument for splitting investment banks from their retail arms. As mentioned in chapter 2, part of the debate in the USA has focused on the decision in 1999 to allow retail and investment arms to exist in the same banking group, by repealing the Glass–Steagall Act in 1933, which had prevented it (and was in turn a reaction to the 1929 crash).

However, the experience of the recent crash indicates that there is little evidence that banks were either more vulnerable or more likely to make bad risk judgements if they had both retail and investment arms. It is just as possible to take on too much risk when signing a deal with a retail customer (indeed that is how the crisis started) as it is when signing deal with a wholesale customer. Politicians are wrong when they draw a distinction between a ‘safe’ retail bank and a ‘casino’ investment bank. In the UK, Northern Rock, Bradford & Bingley and Dunfermline Building Society all had to be rescued; none was involved in investment banking. Similarly Lehman Brothers and Bear Stearns, both of which collapsed, did not have mainstream retail operations. Indeed research published by the European Central Bank is clear that a diversified model of banking is less risky than a specialised one.

In opposition, these facts appeared to be overlooked by the Liberal Democrat party, which made it clear it would favour the introduction of ‘a modernised Glass–Steagall’ act here.³⁰ In government, the Banking Commission chaired by Sir John Vickers appears to be considering breaking up investment and retail. I argue that there is no clear logic for this.

Recommendation 12: There is no evidence to support a case that investment banks should be split from retail banks.

Nevertheless there is a serious concern, at least in the eyes of the public, that investment banks should not be able to ‘gamble’ their retail deposits. We believe this issue is adequately addressed by having higher and countercyclical capital requirements and more effective monitoring of risk rather than by making value judgements on the nature of the companies themselves. Even in the USA, despite initial indications to the contrary by the Obama administration, the efforts of the Frank-Dodd bill to split retail from investment have been watered down to a restriction on large-scale property trading on the part of investment banks.

Despite this analysis there remains a concern that large banks present a greater systemic risk simply because the economic effect of failure is greater than for small banks. For this reason it is important that regulators persist in their efforts to clarify what happens in the event of that failure occurring. All financial institutions should have active so-called ‘living wills’, which spell out how contracts would be unwound in the event of failure. In the words of one of our interviewees, ‘the black box needs to be kept there on the shelf’.

Subsidiarisation

An alternative to break-up could be to require universal banks to subsidiarise their operations within the UK; indeed the Banking Commission may recommend this. Then capital requirements would apply to each subsidiary, thereby avoiding part of the ‘Icesave problem’, when the UK authorities were unable to require Landesbanki to hold more capital because it only registered a branch, rather than a subsidiary, in the UK. (The other part of the ‘Icesave problem’ was that the Icelandic government could not afford to pay out to British consumers what they were owed, even though a compensation system was in place.)

However, this is unlikely to find favour with EU law, where the home–host branch system allows cross-border companies to set up branches within the single market (including the European Free Trade Association). If a company was based in

another EU country, the British regulator could not therefore require a subsidiary in the UK. It would also arguably reduce resilience in the system as it would ring-fence capital for large international banks, preventing resources from being deployed where they are required, not to mention leading to a complex fragmentation of the regulatory system.

It is to European matters that we now turn in the next chapter.

5 Europe - the elephant in the room

Since coming to power in May 2010, the Coalition Government has been conspicuously busy in the field of domestic financial services policy. The domestic regulatory architecture has been ripped up and refashioned, eliminating the FSA, passing its responsibility for macro-prudential issues to a new prudential regulation authority responsible to the Bank of England, with issues relating to conduct and markets going to a new consumer protection and markets authority. The Banking Commission has been set up to look at many of the issues covered in this pamphlet, although much dust will have settled before it actually concludes.

Those interviewed in the research for this pamphlet have had plenty to say about all of these issues, and their views are reflected in the text. But there is a further theme that has arisen again and again, on which British policy makers from all political parties appear eerily silent: the extent to which Britain's competitive position is threatened by its apparent inability to drive (or even sufficiently influence) the European regulatory agenda on financial services.

Bob Wigley, in his report for the Mayor of London on the City's competitiveness, came to the same conclusion. He wrote, 'London's historically supportive overall context is threatened by the increasing influence of EU regulations' and that 'many of the executives interviewed expressed concern that the EU policymakers... have had little interest in preserving London as a financial centre'.³¹

A senior executive at a global investment bank simply told us that 'Britain's success in financial services depends on what happens in Europe.'

This is not a new issue; the Euroscepticism of many people working in City-type jobs in part derives from their frustration at having to react to, and in many cases attempt to correct the

weaknesses of, regulatory innovation from the European Commission in the field of financial services. As one person we spoke to commented, ‘26 out of the 27 countries represented in the European Parliament can exercise power over financial services without any responsibility.’

The situation has acquired a new urgency by the reaction of European policy makers to the financial crisis – to increase the pace of legislative activity and centralise in Brussels the regulatory architecture.

This change of momentum derives from the high level agreements reached at G20 meetings in London, Toronto and Pittsburgh to reform the way that financial services are regulated; since the sector falls under single market legislation the European Commission has taken it upon itself to initiate the relevant legislation, and is supported by many MEPs in doing so.

In February 2011 there are 16 reports related to financial services reform being considered by the Economic and Monetary Affairs (ECON) Committee in the European Parliament, on various subjects including harmonising deposit guarantee and investor compensation schemes, restricting OTC (over-the-counter) derivatives, and requiring greater transparency for short-selling with the potential to temporarily outlaw it and restrict credit default swaps.

There are many more reports in the pipeline, for example on bank capital adequacy (CRD4), bank resolution, MiFID2, total reform and the regulation of credit rating agencies, harmonisation of insurance guarantee schemes, harmonisation of corporate governance relating to financial services, and the solvency regime for occupational pensions. In insurance, the capital regime for the entire sector is being reworked over seven years through the Solvency II programme, which will start in 2012.

Not all of these reports are driven by a desire to boost the single market; some are the result of a misplaced analysis of the causes of the financial crisis. The threat to the UK arises, as the Wigley report identified, because the proposals are not designed with a detailed understanding of the City of London. Coupled with the fact that the final decisions at council level are made by majority rather than unanimous voting, Britain runs the risk of

finding itself subject to decisions that are suboptimal: on at least two recent occasions (over the Alternative Investment Fund Managers Directive (AIFMD) and supervision) Britain has had to back down on its preferred course of action for fear of being outvoted.

There are many examples of Britain fighting excellent rearguard actions to ensure that European legislation in the field of financial services either supports or at the very least does not disadvantage the position of the UK industry. Recent examples include amendments to the AIFMD and work on Solvency II. This is a tribute to the work of senior UK officials in Brussels, British MEPs and the financial services sector working together via teams at the Treasury and FSA.

Unless the British government implements significant structural and attitudinal changes, however, over time European legislation will inevitably chip away at the position of the UK financial services sector. At best, this sector is required to spend burdensome time and effort taking defensive action against European initiatives; at worst, legislation will get through that is not in Britain's interests.

During the course of our research, the situation was summed up by a representative from a global insurance and pension company, who deals with government and regulatory risk: 'The UK's efforts in Brussels are very reactive, we are not shaping anything.'

Matters are not helped by the fact that the reforms to the UK domestic regulatory architecture are distracting officials when they should be focusing on changes to the EU architecture that are taking place at the same time. The FSA is in the process of being disbanded, to be replaced by the new Prudential Regulation Authority (PRA), under the auspices of the Bank of England, with the consumer function hived off to the new Consumer Protection and Markets Authority (CPMA), which will also include parts of the Office of Fair Trading. At the same time an entirely new system of financial regulation has just been set up in Europe, consisting of three main European supervisory authorities: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the

European Insurance and Occupational Pensions Authority (EIOPA).

As the FSA noted in its written evidence to the Treasury Committee inquiry on financial regulation (published October 2010):

With the ever growing importance of the European regulatory regime and framework, it will be essential that the Prudential Regulation Authority and the Consumer Protection and Markets Authority are able to represent the UK's interests effectively internationally. The PRA/CPMA split of responsibilities does not map neatly onto the sectoral split of responsibilities (into banking, insurance and securities markets) of the new European Supervisory Authorities (ESAs), which will come into operation on 1 January 2011, or to the global standard setting committees. The ESAs will determine the detailed regulatory standards that will apply in the UK and have a significant say in how cross-border supervision is conducted.

There is thus a risk that the single UK regulatory voice in some cases is weakened by the fact that two or more organisations will share the representational role in the various international regulatory committees. In other cases (especially in Europe) the UK will only have one vote on each committee and will need to resolve conflicting objectives and interests between the various interested UK authorities. This can be mitigated through clarity in the roles and objectives of, and effective coordination between, the PRA and CPMA. Coordination will also need to extend to The Pensions Regulator and potentially other UK authorities.³²

An executive of a UK-based wholesale financial services trade body expressed the fear to us that ‘we will take our eye off the ball in Europe because we are distracted by the reforms to domestic regulation’.

Recommendation 13: The reforms to the UK regulatory architecture should be reviewed through the prism of needing to maximise UK influence, and minimise compliance burdens, within the European regulatory system.

There are also cultural problems, on both sides. The UK regional chair of a financial services union, who serves on an EU

social dialogue committee on regulation, told us she was unable to fight effectively for the interests of UK plc because no one on the British management side bothers to turn up, because they did not believe in the social dialogue model. Conversely, others have said that since the UK is not part of the euro, their voice is weakened.

In the European parliament, the failure of Conservative MEPs to join a mainstream political grouping is seen as a major disadvantage when it comes to the influence they have in crucial committees. An EU financial services policy analyst explained it to us clearly:

The impact of British MEPs is marginalised by the very large number of Conservative and UKIP members elected in 2009, the former having very little influence following their exit from the EPP, the latter never present... Britain has six MEPs on the ECON Committee but two of them are members of the ECR group so they are not taken seriously. Immediately the UK's voice is diminished.

The main political groups in the European Parliament all take a very pro-EU integration, anti-City stance and have an informal arrangement to support each other in efforts to clamp down on the activities of financial institutions... There is very little that UK MEPs can do about this. They are either isolated within their own political groups on some of the most sensitive issues, or in the case of the Conservatives, they are unable to make significant impact on proceedings, despite having a strong, knowledgeable team. They are prevented from obtaining reports and their amendments largely ignored.

However, others told us that informal cooperation was still possible across the divides of European groupings.

Meanwhile, the familiar theme arises that British voices are not being taken seriously because we are not seen as fully signed up to the European project. One of our interviewees who had high-level experience of working in European institutions remarked in relation to financial services investment said: ‘There is a really unhealthy attitude among some in the EU that seems to say that “if we can’t have it, then London shouldn’t either”’. And with less than 2 per cent of European Commission staff

being from the UK, and the failure of Britain to construct mainstream career paths for British civil servants in and out of the Commission, the list of people on whom we can call to press British interests is dwindling.

Part of the problem is that within Whitehall the European dimension of policy is often perceived as an add-on to the domestic agenda, rather than as essential to achieving mainstream objectives. Such thinking must be avoided in relation to the regulation of financial services, since it is becoming ever more obvious that the European dimension is crucial. The rapid rotation of junior ministers prohibits the building of long-term relationships between European ministerial counterparts, which can be used to smooth negotiations at the crucial stages. Although senior staff at the UK Permanent Representation to the EU (UKRep) are often Whitehall's best, they often lack ministerial backing on the bread and butter issues in Brussels to do their jobs effectively.

To maintain Britain's pre-eminent position as the global number one in financial services, the UK needs to turn its relationship with Europe on its head. Britain should see our membership of the European Union as an opportunity to enhance our competitive position in financial services, and the EU's structures a mechanism through which this can be achieved. We should invest the time and resources to making legislation work for us, and therefore for Europe as a whole, rather than persisting with a defensive and reactive position.

Such a change will require cabinet-level determination, and a Whitehall machine dedicated to ensuring that the pan-European regulatory platform will allow London to fight off the competitive threat from Hong Kong and Singapore. Under the current division of responsibilities within Whitehall, this machine should be located in the Treasury. However, there may be an argument that sponsorship of the financial services industry should be shifted to the Department for Business, Innovation and Skills in order that the person responsible for championing the sector is the industry secretary. This would make some sense given their general business sponsorship role and as many other issues routinely considered by BIS also have

strong European dimensions, but coordination with the Treasury would still be required given that many of the relevant issues eventually come to the Ecofin Council. This issue is discussed in the recent Demos pamphlet *National Treasure*, which concludes that the City minister should span both departments, with the routine industry sponsorship role, plus the appropriate people and resources, shifting from the Treasury to BIS.³³

It is worth noting in this context that the current government in opposition promised a full-time Treasury minister responsible for, and largely based in, Brussels. This has not materialised, a fact that many interviewees found regrettable.

At present, there is ineffective coordination within the industry, with many trade bodies putting out a lowest common denominator position that is of little use either to European Commission officials or to the companies they purport to represent. The new minister should be responsible for mapping influences across Europe and ensuring that effective lobbying strategies of the Commission, Council, Parliament and new EU regulatory bodies are coordinated between the relevant companies, British MEPs, officials, regulators, trade bodies and ministers at their appropriate level. By bringing together the key players, the minister would provide an opportunity to listen to industry and find out what their key areas for positive action were, while coordinating defensive action in other areas. It would also send a strong signal that Britain was ready for business in Europe and had something to offer as well as something to defend.

In the words of one of our consultees:

The most effective way to engage Brussels is to be proactive in defining the forward agenda. This is something the UK has not been able to do effectively in the wake of the financial crisis.

Recommendation 14: The UK government should demonstrate a cabinet-level determination to lead the European agenda on financial services. This should include developing stronger career structures for UK graduates, civil servants and business people seeking to gain experience of working in the European Commission.

Such a colossal change in approach will take time, but yield major dividends.

Final word

There will always be financial crises. By definition, we won't know where the next one is coming from until it happens; our task in the meantime is to make our system more resilient so we can mitigate the effects when it comes. However, in doing so, we need to make sure that we don't throw out the baby with the bathwater. Britain is good at financial services, providing revenue to the Exchequer and jobs to many people. While there is much that can be done to regulate the sector more effectively, a deliberate policy to 'rebalance' away from the City or weaken it by punitive break-ups, taxation and regulation is not in our long-term interests.

If our recommendations are enacted, not only would the likelihood of a future financial crisis be lessened and its severity reduced, but we would have exploited the experience of recent events to correct some of the weaknesses that have grown up in our financial services sector over time.

We may not ever come to love our bankers, perhaps deep down we do not want to, but we should be able to have a properly informed and open debate on the limits of their operations. By doing so, we can shape the type of financial services sector that we want, and so better realise its potential to contribute to the British economy.

Notes

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Following the financial crisis and the bailing out of the banks, public opinion of those working in financial services has hit a new low. The public blames bankers for the crisis and the subsequent recession. This suits politicians as it shifts the blame away from them. Indeed, some have argued that there is a need to ‘rebalance’ the UK economy away from financial services.

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This pamphlet argues that the public debate about stability in the banking sector should not be informed by gut mistrust or unease about the financial markets and how they work. Instead the Government should look to understand the root causes of the crisis, to shape the type of financial services sector that we want, and so better realise its potential to contribute to the British economy.

Kitty Ussher is the Director of Demos.

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ISBN 978-1-906693-64-0 £10

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