The Future of Banking Commission

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Commissioners

RT HON DAVID DAVIS MP (CHAIR)
David is chairing the Future of Banking Commission. He is Conservative MP for Haltemprice and Howden and is a leading campaigner on civil liberties. His former roles include Shadow Home Secretary, Conservative Party Chairman and Chairman of the Public Accounts Committee.

RT HON JOHN MCFALL
From 2001-10, when he retired as Labour MP for West Dunbartonshire, John McFall was Chair of the influential House of Common's Treasury Committee. In January, he was presented with the award of Which? Consumer Champion for 2009 for his role in improving financial services for consumers.

RT HON DR VINCE CABLE MP
It was in his capacity as the Liberal Democrat Shadow Chancellor of the Exchequer that Vince served on the Commission. In May 2010 Vince was appointed Secretary of State for Business Innovation and Skills.

PETER VICARY-SMITH
Peter is the Chief Executive of Which?, the UK's largest consumer body. Peter's experience has been gained in both the charity and commercial sectors. He took up his appointment at Which? in August 2004.

PHILIP AUGAR
Philip is formerly a Group Managing Director at Schroders' and now a writer on the financial services industry. He is the author of '*The Death of Gentlemanly Capitalism: The Rise and Fall of London's Investment Banks*'.

CLARE SPOTTISWOODE
Clare is currently the Chair of Gas Strategies Limited. Her career started as an economist with the Treasury before establishing her own software company. Clare is perhaps best known for her role as Director General of Ofgas between 1993 and 1998.

DAVID PITT-WATSON
David is Chair of Hermes Focus Asset Management. He also advises civil servants and senior politicians on issues of industrial and financial policy.

ROGER BOOTLE
One of the City of London's best-known economists, Roger runs the consultancy, Capital Economics, and is also a Specialist Adviser to the House of Commons Treasury Committee.

The Rt Rev Christopher Jamison (Abbot of Worth) acted as an advisor to the Commission.

Anticlockwise from top right sitting around the table: PHILIP AUGAR, PETER VICARY-SMITH, RT HON JOHN MCFALL, RT HON DAVID DAVIS MP, DAVID PITT-WATSON, CLARE SPOTTISWOODE

Contents

Welcome

from the Chairman David Davis MP

We have established an independent banking commission

In 2010, Britain is emerging from the worst financial crisis of our lifetimes, a manifestation of a deep-rooted and persistent set of problems. Banking is a structurally flawed industry that has failed its customers, its investors, and the taxpayers who stand behind it.

The political and economic costs have already been enormous. We have lost over 16 million jobs around the world. Banks have had to write down $2.3 trillion of assets.

The problem is even more important for Britain. Banking sector assets in the UK are five times the size of our GDP, a ratio greater than the USA, Canada, or the Eurozone. When disaster struck in 2008, the government stepped in to avert complete economic collapse. The financial crisis caused substantial damage to the economy and the rescue cost the British taxpayer billions of pounds.

Financial crisies are nothing new in human experience, certainly not in modern experience. No financial crisis has been identical to any of its predecessors, but institutional memory is short and individual memory is even shorter. Yet another catastrophe of our own creation has reared its head, and devising a comprehensive solution has proved itself a challenge to our best minds.

Each crisis has been bigger than the last, and without intelligent and decisive action, the next one may be bigger than the British economy can afford.

We can identify themes that played a central role in 2008: over-leverage, mis-pricing of risk, misunderstanding of products, and cheap credit, all concealed by concomitant asset price inflation and opaque accounting practices. In response to the end of each asset bubble of the past two decades, central banks introduced expansionary monetary policy. Instead of allowing several small market corrections, the cycle of monetary expansion fuelled one big collapse in 2008.

Banks enjoy an implicit guarantee from the government because the core services they provide are considered essential to the economy and to society, much like a utility. The political cost of another financial crisis would be so high that it is impossible entirely to remove this implicit government guarantee. Britain cannot afford to leave the taxpayer open to an unlimited assault on the public purse. The best option is to make the guarantee explicit and tightly circumscribed.

The Commission has considered some of the most intractable financial problems facing our society today. Living wills need to be stronger to limit the taxpayer guarantee and reintroduce market discipline. We need to resolve conflicts of interest within universal banks, and the problem of banks that are too big to fail. The banking industry has had a high degree of rivalry, but not enough competition effectively to deliver good products and services to clients. Rather, firms have taken advantage of market failures such as information asymmetry. We need a regulatory system that will reintroduce the rigours of effective competition and market discipline to financial services. The possibility of failure must be real enough that banks will manage their own businesses prudently. The formalisation of international accounting rules had the perverse and unintended effect of reducing the requirement on accountants to exercise judgment in signing off balance sheets. As a result, one of the historic checks on asset value was undermined.

This is a complex, multi-causal problem with multi-part answers. Nevertheless, in this report the Commission has endeavoured to provide a clearer understanding of the financial system, and to recommend that the new government implement practicable solutions to the problems we face.

We would like to thank all those who contributed to the report. A special thanks goes to those who attended the Which? Big Banking Debate, to the many witnesses at the public events and to those who provided comments on the report during its development.

The Rt Hon David Davis MP
Chairman

Executive summary

We established this Commission because the public's voice has not yet been sufficiently heard in the ongoing debate about the future of banking. Our cross-party approach and the fact that we have heard from so many members of the public as well as banks, regulators and experts gives this Commission its unique perspective. All were united in wanting a banking system that is secure, profitable and that properly fulfils its crucial role in society.

To date responses to the crisis have tended to focus on rebuilding the capital of the banks, to make them more secure. Yet what struck us is not just the problem of bank solvency. Rather it was the degree to which the financial crisis highlighted systemic problems in a sector that had, for a long time before the crisis, failed to deliver for its customers or for society at large.

Putting more capital into the banks, and then returning to 'business as usual' is not enough. We need to build a sustainable banking sector, focused on delivering value to the economy outside its own financial world. To do this requires significant reform to the structure, regulation, governance and culture of the industry.

Not too big to fail: Reforms to the structure of banking

The first area of reform is the structure of banking. This should ensure that there is no advantage received by banks or their creditors who behave imprudently. Where wrong decisions are taken, they should not threaten people's savings or the stability of the financial system.

The government currently provides an implicit guarantee to banks to support the stability of the financial system and the continuity of core services. This subsidy enables banks to reduce their borrowing costs and run higher levels of risk and leverage thus increasing the likelihood of taxpayers being forced to step in and support the banking sector.

Banks need to be structured so that they can fail without catastrophic damage to their customers or the economy. An indispensable first step is the introduction of a system of transparent and public 'living wills' detailing how the collapse of a bank would be managed. These should ensure that within any banking group the core deposit and lending functions and the payment system are ring-fenced. They should also set out how customers would be treated in the event of failure.

Depositors need better protection; it is simply not acceptable for individual depositors in UK banks to discover that they have unwittingly put their savings at risk through the misguided actions of some banks in parts of the capital markets. The extent of depositor protection must be made clear and transparent to consumers, and individual depositors put first in the ranking of creditors. A new class of 'safe haven' accounts should be established with a 100% guarantee, but which would only be invested in safe assets.

We received powerful and persuasive evidence from expert witnesses in favour of restructuring the banks. The compulsory separation of banking activities has the potential to solve many current and persistent problems and the government's new commission should consider urgently and in great detail a structural solution to the problems caused by large, integrated banks.

In any case, we also believe the UK government should, with its international partners, create a structure which addresses the conflicts of interest inherent in much of investment banking. To this end we would go further than the so-called Volcker rule and seek a separation of investment advice from the execution of trading.

We note the huge growth in securities and derivatives markets, and we also propose reforms to make these more transparent, and less open to creating systemic problems.

Effective competition: a new approach to regulation

A new focus of banking regulation should be to ensure that competition delivers benefits for those the banks are there to serve and that bankers, not regulators, should take primary responsibility for the management and stability of their banks.

We recognise that at present, the nature of the banking industry creates temptations to profit in ways which do not deliver value to consumers. So, for example, our witnesses have noted that banks are able to deliver short term profit from taking on risk, to sell products profitably that do not meet customers' needs, and to do all this with other people's money. Complaints about banks are increasing and significant criticism has been made that product choice, suitability and selling practices operate against consumers' interests.

These characteristics of the financial services industry make the introduction of competition difficult. In our view that means that all the more effort needs to be put into how effective and beneficial competition can be established in financial services. In an industry so fraught with conflicts of interest, consumers need better protection. Regulation has failed to make banks, and other financial institutions, properly subject to the rigours of effective competition.

Consumer protection regulation should have a primary duty to promote effective competition so that competition provides market discipline where possible. Where it is not possible the regulator would intervene so as to mimic the beneficial effects of competition.

As the financial crisis deepened, significant taxpayer support was required to prop up failing banks. This is unacceptable. However, instead of simply ensuring banks are refinanced, regulation should concentrate on ensuring that if in the future banks do fail, they pay the price and never again threaten to create unacceptable social costs.

To do this, the Commission considers it vital that the prudential 'safety' of banks be the responsibility of their boards. It should not be delegated to regulators. The ultimate purpose of prudential regulation cannot be to bail out the banks, but to ensure that banks can fail but without significant harm to vital banking services. Where a bank is too big, or otherwise too significant to fail, the prudential regulator would intervene to restructure it.

A healthy culture: checks and balances in an ethical framework

The third area of reform is in the governance of the banks. We need to see greater independence and professionalism amongst those charged with overseeing their operations. We have heard how, over the past few years, those who might have urged caution failed to do so: board directors, shareholders, accountants, auditors and credit rating agencies. We need to re-enforce the independence and professionalism of all these agents.

Therefore one of the key recommendations of this report is to strengthen all these areas of corporate governance, from the duty of fund managers to the operation of the credit rating agencies. We have recommendations for reform of accounting and audit, an area which we believe is in danger of being overlooked, designed to enhance the role of the professional auditor in maintaining the integrity of our financial system.

Remuneration practices within banks have been a key source of concern. Senior executives should be rewarded for long-term business performance and shareholder return. To tackle mis-selling and the sales-based culture disliked by customers and branch staff alike, banks should cease rewarding frontline staff for increasing sales. Instead they should receive bonuses linked to levels of customer satisfaction, the fair treatment of customers, and resolution of complaints.

These reforms will help usher in a new culture for the banking system. That culture should be underpinned by an explicit acceptance by bankers and others in financial services of the duties and responsibilities they owe. Bankers, like doctors, teachers and lawyers, should be trustworthy professionals motivated by the service which they and their institutions provide. This will require a new approach to defining the culture within financial organisations and ensuring that all levels of the organisation adhere to it. To bolster this cultural change we want to see bankers engage in the same sort of professional standards training undertaken in other professions, with the same remedies and sanctions applied where individuals fail in their duty of care.

Our recommendations add up to a radical overhaul of the banking system, a programme that not only seeks to prevent the last crisis from happening again, but which also addresses the systemic problems which have destroyed the trust between many banks and their customers and which have at the core the seeds of another, unforeseen catastrophe. It aims to create a banking industry of which its participants, and the society they serve, can be justifiably proud. ■

List of Recommendations

A) Structure

Resolution regimes

1. The Commission is supportive of proposals for living wills as a step towards reducing the government guarantee and re-injecting market discipline by allowing banks to fail. The living will should ensure that within any banking group the core deposit and lending functions and the payments system are ring-fenced with their own separate balance sheet, liquidity and funding mechanism.

If it is to have a behavioural effect, the living will cannot simply be a private exchange between the bank and its prudential regulator. Rather, it must be a public document.

Depositor protection

2. The Commission believes the £50,000 limit should be applied to each brand rather than to each licensed institution. The Regulator should also prevent the misleading promotion of products which claim to provide a guarantee of capital, but which are not covered by the compensation scheme.

3. There should be clear signs on all bank tills, websites and other promotional material produced by financial services firms informing depositors how much of their deposit is insured by the FSCS.

4. A new class of deposit should be created, which carries a 100% guarantee, but which should only be invested in 'safe' assets such as government bonds. This idea was put forward to the Commission by Mervyn King.

5. Depositor protection should include reform to the bankruptcy procedures so that the rank of creditors is changed to put depositors at the top.

Should there be a formal separation of banking activities?

6. The living will is an absolutely indispensable first step to reform the financial industry, but we need to consider structural reform as well. The commission has received powerful and persuasive evidence from expert witnesses in support of restructuring the banks. There can be no prevarication on this crucial issue since the compulsory separation of banking activities has the potential to solve many current and persistent problems. Therefore the government's new commission should consider urgently and in great detail a structural solution to the problems caused by large, integrated banks.

Breaking up investment banks

7. Extending the Volcker rule to prohibit banks that advise clients from trading any form of securities, and separating corporate advice from investor advice, would address many of the problems that integrated banks create.

8. Breaking up the banks would be a major recasting of the global financial system. But it would eliminate conflicts of interest from most parts of the banking system and would contribute to a safer system by reducing the scale of individual banks. It would require global consensus and co-ordination but the UK is one of the world's leading financial centres and we encourage the UK government to initiate global debate on this issue.

Derivatives trading

9. All securities above a certain size shall only be tradable if they are registered on a system such as the Stock Exchange Daily Official List (SEDOL).

10. Investors, speculators and traders should have to disclose material positions in a company, no matter whether these positions are held as stock, options or other derivatives, or whether these positions are short or long.

11. There should be a thorough review of margin requirements and of all derivatives trades, whether these be undertaken through exchange trading or central counterparty clearing. The price and volume of all securities and derivatives trades should be known when the trade takes place.

12. The Commission notes the growth of off-market trading in equities and other securities, and the existence of 'dark pools' of supply, and find it difficult to believe that these add to the stability of the market. We would recommend a thorough and ongoing review of these developing practices.

PETER VICARY-SMITH, CHIEF EXECUTIVE OF WHICH?

B) Regulation

13. There should be a significantly different approach to regulating banks, to ensure there is enhanced competitive protection for the consumer, and that the stability of the financial system is maintained, without putting taxpayers at risk. In practical terms, this entails splitting regulation of the financial sector into three distinct functions, each with a different remit:

- Consumer protection regulation
- Prudential regulation
- Systemic risk regulation

Consumer protection regulation

14. The regulator responsible for consumer protection regulation should have both: (a) an explicit mandate to promote effective competition in markets in the financial sector; and (b) the necessary powers to regulate the sector to achieve this, including the ability to apply specific licence conditions to banks and exercise competition and consumer protection legislation. These powers will be concurrent with the competition powers of the OFT, and will enable the regulator to both enforce competition law and make market investigation references to the Competition Commission.

15. We are in favour of exploring further a number of specific measures that could be taken by a regulator with a dedicated remit for consumer protection:

1. Ensure customers can easily transfer products and accounts.
2. Ensure customers with overdrafts are not overcharged.
3. Set ‘default’ settings on services, products and accounts in the customer’s best interest.
4. Allow customers to choose to ‘opt-in’ to unauthorised overdrafts.
5. Ensure banks do not take advantage of existing customers.
6. Act to prevent obscure charges or unfair, asymmetrical contract terms where these are present in financial products and services.
7. Ensure full and transparent disclosure on all products.
8. Consider introducing standard products for some basic services which all retail providers have to provide, and a common form in plain English to explain the key terms so that customers can easily compare products provided by different providers on the same basis.
9. Empower customers to seek compensation via a collective redress process.
10. Promote bank retail depositors to rank ahead of all other creditors, including bondholders.
11. Ensure consumer deposit accounts clearly highlight whether or not they are covered by the Financial Services Compensation Scheme (FSCS).
12. Prohibit those commission structures which incentivise mis-selling.
13. Firewall conflicts of interest, and if the conflicts are intractable, force structural change to address the problem.

Prudential regulation

16. The Regulator must change its approach from attempting to prevent failure to ensuring banks can fail, but without significant harm to vital banking services. The Commission believes relying on greater and more intense supervision is the wrong approach. The prudential regulator would take pre-emptive steps to:

- Protect ordinary depositors, including by putting basic deposits above all other creditors in the liquidation preference, as discussed in chapter two;
- Ensure the continuity of all essential services provided by an institution; and
- In the case of any institution that is too big, or otherwise too significant to fail, intervene to restructure that institution such that its failure would no longer present a systemic risk.

These proposals have two important implications. First, the prudential regulator will be the guardian of living wills. It will supervise the introduction of, and monitor, living wills with the powers required to ensure that essential services continue to be provided even after a bank has failed. Second, the prudential regulator will have specific powers to restructure banks where it is not possible to construct a credible living will.

Systemic risk regulation

17. The purpose of systemic risk regulation is to oversee liquidity and capital standards at a macro level, and to translate the macro standards down to individual firms. It is concerned with the inter-dependence of banks and their exposure to common economy-wide shocks that may affect key sectors, such as commercial and domestic property. Its role is to act counter cyclically, to ‘take the punch bowl away’ when asset price bubbles grow unsustainably. This is not an easy task, and the organisation has to have the credibility and the backbone to run against the market.

Conflict in regulatory objectives

18. The duty to have regard to ‘the international character of financial services and markets, and the desirability of maintaining the competitive position of the United Kingdom’ should be abolished as a specific objective when regulating banks. This objective creates a conflict of duty and tends to support the status quo and discourage new entrants. International competitiveness is best served by ensuring that domestic banks are able to compete effectively, without subsidy or special treatment. Promoting the success of British industry is a job for the government and the industry trade bodies, not for the regulator.

Independence of the management boards of the regulators

19. In future, the board of any financial services sector regulator should be balanced to comprise members who are independent of the industry, while also having members with the background and skills necessary to understand the workings of the financial services sector.

C) Culture and corporate governance

Bank directors and boards: right people, right duties, right resources

20. The Commission recommends that the Companies Act be clarified and, if necessary, reinforced by a change that requires directors to give consideration to the effect of a company's activities on the stability of the financial system as a whole, even where this conflicts with a narrow definition of shareholders' interests. There should be a statement in the accounts to the effect that directors believe they have fulfilled this duty.

21. The Commission recommends that non-executive directors should make greater use of their powers to appoint independent advisers to assess risk and to measure customer experience through commissioning their own research. These reports should be disclosed to shareholders.

22. Non-Executives should be charged with particular tasks and particular areas where their 'challenge' is expected. This would help focus the minds of both non-execs, and the rest of the board, on creating a comprehensive skill set. Stakeholders could compile a list of people who would be well qualified as bank directors, and encourage the chairmen of the nominations committee to consult this list before making appointments. If bank behaviour does not change, we believe giving stakeholders nomination rights to the board should be considered, similar to the systems in Sweden and Italy where minority shareholders have nomination rights.

Remuneration: right incentives

23. The Commission recommends that remuneration structures for senior executives need to be far longer-term in nature, with reward for financial measures aligned to return on assets, and the creation of sustainable long-term absolute shareholder value over a 5 and 10 year period. There should be no reward for increasing return on equity or earnings per share, which can be accomplished by increased leverage and taking extra short-term risk.

24. Rewards for senior executives in retail banking should be linked to customer measures including overall satisfaction, complaint levels and their fair resolution and regulatory compliance. The details of these measures should be available on the bank's website, for senior executives as well as for directors.

25. The Commission recommends that remuneration for frontline and branch staff should not be linked to sales, and should reward customer satisfaction the fair treatment of customers, and the fair resolution of complaints. There should be no commission or bonuses received for selling products.

26. In the interim, the FSA should make it clear that institutions which do not adopt this rule will be subject to close scrutiny, and that senior management will be subject to enforcement action for any remuneration structures or sales targets which contribute to mis-selling by putting excessive pressure on frontline staff.

Corporate governance: shareholder oversight and trustee duties

27. The Commission believes trustee bodies holding shares and other securities have responsibilities of ownership, and should not only be allowed, but should indeed be expected, to exercise them. The law could usefully be clarified on this point.
As a matter of course, contracts between trustees and agents managing shares on their behalf should ideally incorporate the same fiduciary duties which a trustee owes to their beneficiary.

28. The Commission recommends that implementation of the Stewardship Code for Institutional Investors be mandatory for those fund managers which own bank shares. Shareholders should also be able to state that they ask the boards of banks to 'generate value in the long-term, and to avoid undue risk' or, if they have different goals, should be explicit about what those goals are. Fund managers should report by what process they seek to influence banks, and should report actual engagement activity, and its relative success or failure in influencing management practice.

UK Financial Investments (UKFI)

29. The Commission recommends that UKFI works as an active shareholder, not only to encourage the restructuring of the two UK banks of which it is the majority owner, but also to work with other shareholders to ensure that, at the point of disposal, the structure of the UK banking industry is sustainable for the long-term. This should be done in coordination with other shareholders, and its aim should be to help ensure the implementation of the recommendations of this report. In particular, UKFI should work to ensure the needs of long-term shareholders, individual customers, households and firms are placed at the heart of a transformed banking system.

30. The government should be held to account to ensure that UKFI applies a public-interest test to its restructuring and final disposal of public shareholdings or ownership of banks, to ensure the architecture of the industry is safe, and that competition is stronger post-divestment.

Corporate governance: accounting and auditing

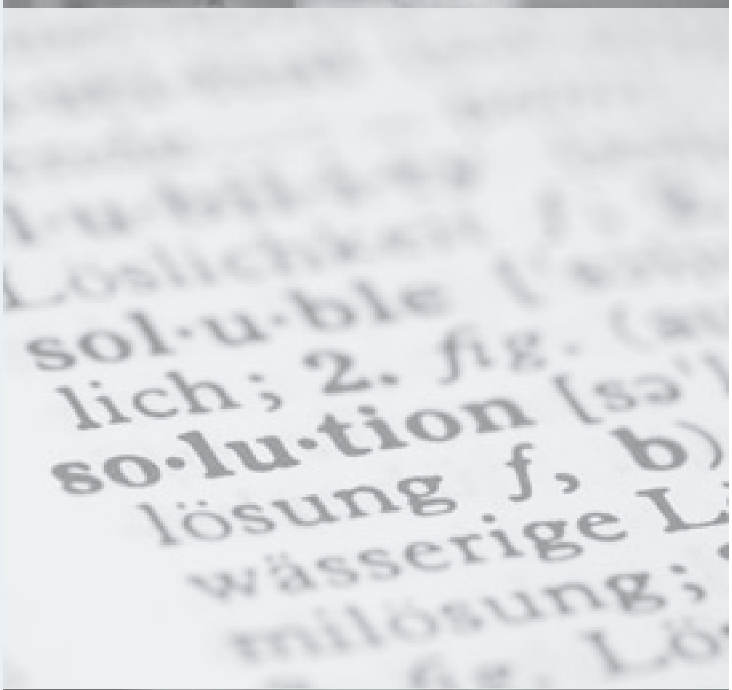
31. There need to be fundamental questions asked about the purpose of the audit. The Commission is concerned that auditors failed to report on the higher levels of risk and leverage being run by the major banks.

32. There should be a reinstatement in law of the principle that financial accounts represent a 'true and fair' statement of the position of the company, and that they are presented in a way which places substance over form.

33. Auditors should be asked to attest that bank accounts represent a 'true, fair and comprehensive statement' of the affairs of the company, and that they are prepared in keeping with the spirit as well as the letter of solvency and other regulatory requirements.

34. The accounting principle of 'prudence' or 'conservatism' is relevant when determining whether an asset is recoverable, and therefore has its place in determining loan loss provisions. The quest for 'objectivity' also has its place, through mark to market and other devices, where doing so provides meaningful information (either in the balance sheet or in the notes). Having a robust classification criterion for assets and liabilities, so they are classified appropriately, either at cost or at fair value, is critical to ensuring the numbers reported are meaningful and relevant. Regardless of the measurement basis, there is no substitute for the professional judgement of the auditor.

35. The auditor should be required to report all significant risk factors which come to their attention as part of the audit. The FSA should extend its current trend of encouraging much more dialogue with auditors and the FSA should require further work from the auditor of any areas of a bank's activities where they have concern. It is important that early work is done to nip things in the bud, and auditors are well placed to help in this activity. This does, however, depend on improving the level of dialogue between the auditor and the regulator. In the unlikely event that auditors find that this creates a conflict of interest, their duties should be clarified to deal with this point.



Corporate governance: credit rating agencies

36. The key problem is that rating agencies compete to offer a better service to those who issue bonds, rather than to those who buy them. For practical reasons, it is difficult to receive income from the many thousands of institutions and individuals who may buy a bond. However, it would be possible to remove conflict of interest if, for example, a bond issuer was 'assigned' a rating agency, rather as a judge might be assigned to try a case. Rating agencies which could show they delivered accurate ratings could be assigned more work, to give an incentive for them to improve their performance, and indeed to encourage new entrants to the market. Alternatively, buyers of bonds could be asked to set up a not-for-profit organisation to review the CRA's ratings. The funding for these proposals could be raised by a levy on bond issuance.

A code of conduct for the banking industry

37. The Commission recommends the development of a 'Good Financial Practice Code'. This code should have a similar status amongst the banking profession as similar codes of conduct have in the medical and other professions.

38. In addition to the development of a Good Financial Practice Code, the Commission recommends that bankers receive compulsory formal training before they are able to fully practice in their profession. This should include training in the ethical behaviour expected of the members of their profession, including how to resolve conflicts of interest.

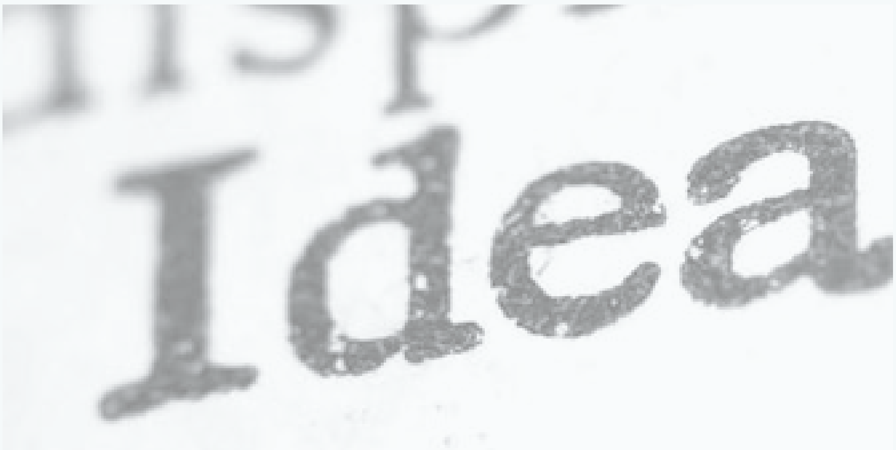
39. The Commission recommends that this Code should be devised and enforced by a new professional standards body along the lines of the General Medical Council, or the Legal Services Board. ■

Chapter one

Why we have written this report

Four core beliefs underlie this report

- Banking matters
- The banking industry has fundamental problems
- Current banking reform won’t solve them
- We need a new approach which recognises why banking is different



Banking matters

An effective banking system is essential to the working of a modern economy. Although much heat has been generated about whether parts of our financial markets are 'socially useless', a key lesson from the crisis is that banking is so fundamental to society that governments had no choice but to support it. The alternative would have been economic collapse. It is therefore of profound importance that we have a sustainable banking system which serves the needs of society efficiently and effectively. This is particularly true of the UK where the financial services industry employs over a million people and, led by banking, has contributed between 5% and 8% of national output over the past decade.[1]

Evidence from Robert Peston

'One of the things that seems to be slightly odd about banks is if you look at social [and] economic institutions, it's very hard to think of any… that does [anything] that is more useful. They take surplus savings from people who don't really know what they particularly want to do with them at any particular moment, and convert that into loans to households who may wish to buy a property; or to businesses that need finance for investment. This is an absolutely extraordinarily valuable…social and economic function.

'And looked at another way they also provide a bit of social mobility. If we didn't have banks prepared to engage in that kind of maturity transformation, the only people who would be able to invest in businesses or buy houses would be people who've inherited vast amounts of wealth.

'So all of this is fantastically useful, and the only reason I was thinking about it in those terms is it is absolutely extraordinary, given all this useful stuff they do, that their reputation is so unbelievably poor.'

Lord Turner has pointed out that all parts of the industry may not have an equally valid social purpose. Some parts of the banking industry matter more than others; but all those who gave evidence to the Commission, including regulators, academics, banks' customers and bankers themselves, broadly agreed that the essential functions of the banking system are:

1 The facilitation of payment: the agreement and mechanisms to distribute cash and credit payments between individuals and businesses, including access to direct bank transfers (BACS and CHAPS), card payment systems and ATMs;

2 Co-ordination: bringing savers (deposit holders) and borrowers (investors) together, despite the different sizes of funds or different timings in the demand for money, by offering a return on savings and lending at interest; and

3 Risk management: pooling the deposits and diversifying their risk by lending to a diverse range of borrowers.

Box 1 contains some of the views on the function of the banking industry, expressed during the Commission's evidence sessions. The Commission believes John Kay's observation, that the value of banking lies in the services it provides to the world outside, not to activity within the financial system, is of particular note.

The banking industry has fundamental problems

Banking changed dramatically in the 1990s and early 21st century. Historically, it had been a straightforward business, in which banks collected deposits from savers, and then lent these out to borrowers. Over time, banks themselves became part of wider financial conglomerates, which led to new risks and conflicts of interest. But this basic model was recognisable as late as the year 2000, when the British banks, between them, loaned out no more than they held in customer deposits.

Between 2000 and 2007, powerful forces, which had been building for more than a decade, transformed the industry. The trigger was the deregulation of the US banking industry in the 1990s, which enabled the previously heavily restricted US banks to undertake a wide range of activities. These new practices formed the template for banking in other countries. One important development was the increasing use of securitisation, a new financial technique that enabled banks to slice and dice the loans they had made, and sell them on to others. (See Box 2, p16, for more detail on securitisation.)

John Wright, chairman, Federation of Small Business

'I think the banks have got a big job to actually try and restore the confidence of small businesses in their service, without any shadow of a doubt, and they have to work much harder than they are at the present time'

BOX 1: VIEWS ON THE FUNCTIONS OF BANKING

John Kay, visiting professor, London School of Economics, and fellow, St John's College, Oxford
'We measure the contribution of banking by what it actually contributes to the non-financial economy. Firstly it provides a payment system, and the deposits which are associated with it. Secondly, it matches people who want to borrow, with people who want to save. Thirdly, it helps them manage risk in various ways and, in doing that, it enables people to make provisions for their retirement, investment, things they don't want to consume immediately, and it manages risk both as far as the non-financial economy is concerned, and potentially as far as households are concerned. It's these elements that are...the value-added that the financial system creates.'

Mervyn King, governor, Bank of England
'I think you could divide the functions of banking...in its widest sense into three... the operation of the payment system and, connected with that, the system of retail deposits, checking accounts for ordinary families and businesses;...the intermediation services between saving and investments are a key part of banking sector's role though not exclusively banking;... the third part is the allocation of risk.'

Stephen Green, chairman, HSBC
'You cannot have modern social and economic development without a flourishing, profitable, vibrant, robust, stable banking system...The banking system is the main garner of people's short term savings... and because it is, certainly for the retail end of the market, [it is] the main provider of credit services... Through wholesale activities...[it is] a key provider of liquid, stable, predictable, transparent trading markets within which, institutions like large multinational corporates, can meet their legitimate needs.'

Brendan Barber, general secretary, TUC
'We need to re-orientate the fundamental purposes of the financial system in a way that's directed to meet the needs of the real economy.'

John Wright, chairman, Federation of Small Business
'Our members' needs are quite simple. They want a safe and secure banking system that is reasonably accessible and not costing a fortune. And in fact, to some extent, they would rather see [safety] and security and actually pay a little bit extra knowing that in fact that money is available. But banks seem to have lost their way.'

Banking consumer
'I am aware that banks are not in business for their health, but it is time they, whom we put in charge of our money, responded in a more honest and customer focused manner. They keep telling us how 'important' we are, so prove it.'
Anon, www.bnbb.org

▸ The banking model changed from 'originate and hold', where banks retained the loans they had made, to 'originate and distribute', which allowed them to sell the loans they had made, and to buy loans from other banks. Banks also turned to the securities markets to fund themselves. This allowed the banks to hugely expand their lending and to reduce the amount of capital they were holding to support this lending.

British banks adopted this new model enthusiastically, and by 2008 were lending out around £800bn more than they had on deposit. Building societies, which used to have a very narrow range of activities, were transformed or absorbed into broad banking institutions. Three of Britain's largest banks, through growth and acquisition, became international global financial institutions. The banking sector began to overshadow the entire economy. In 1964, the total assets of UK banks amounted to 34% of GDP. In 2007, that figure was nearly 500%, a near fifteen-fold increase relative to GDP.[2]

The development of new and ever more complex security products expanded rapidly. While giving evidence to the Commission, Lord Turner presented figures showing that asset backed securities, such as those funding mortgages, had risen from some $200bn in 1995 to $2.3 trillion in 2006. Derivative financial contracts, in interest rates or foreign exchange for example, reached a colossal scale. Interest rate derivatives, which were almost non-existent 20 years ago, now have a nominal value of $350 trillion. Lord Turner summed up the effects as follows:[3]

> 'Leverage – measured by debt to GDP – has increased significantly...Innovation has driven complexity, with a massive development in the past 20 years of complex securitisation and derivative products...Trading volumes have increased hugely... There has been an increasing 'financialisation' of the economy. Financial firms have accounted for an increased share of the GDP...there has been a sharp rise in income differential between many employees in the financial sector and average incomes across the whole of the economy.'

For many years, this was a source of pride rather than anxiety. Many, including most regulators, believed that this increase in activity would reduce the risk within the financial system. They believed markets were always effective at judging value, and tended to create discipline and stability; and that mathematical models of past behaviour could be used to judge risk accurately. The banking crisis of 2007 exposed this to be wrong. When

Participant Big Banking Debate

'Banks don't value customers – they view us as cash cows'

the world changed, the models did not work. Risk had been transferred and concealed, not reduced. And it had been amplified by modern financial instruments, such as derivatives, and the consequences compounded by unforeseen linkages in the newly connected global economy.

The flaws in the model are evident at many levels. Within the integrated banks, losses from the riskier investment banking activities can put the deposits of their individual current account and savings customers at risk. Potential conflicts of interest are rife. Pricing is opaque. Competition appears not to work. Customers are dissatisfied. Shareholder value has been eroded. Damage has been caused to the real economy. These issues are systemic, not just confined to a few badly run banks. The market for banking services, both at a wholesale and at retail level, does not consistently generate the incentives for companies to work in the interests of their customers. In a well-functioning market, the forces of competition would encourage banks to deliver essential services ever more effectively and at ever lower costs. In banking, they have not done so. This leads the Commission to the inescapable conclusion that this is an industry with fundamental problems, which is in need of radical reform.


ANTONY JENKINS

Evidence from Antony Jenkins, chief executive, global retail banking, Barclays

COMMISSIONER Still on the same point, did you say that two-thirds of your customers are either satisfied or very satisfied?
ANTONY JENKINS Yes.
COMMISSIONER And then 1% complain?
ANTONY JENKINS Yes.
COMMISSIONER That means then that one third of your customers are less than satisfied?
ANTONY JENKINS That's correct.

Current banking reform won't solve the industry's problems

In contemporary economics, there are few more important problems than fixing the broken banking model. The cost of public support to the banking system is both unacceptable and unsustainable. The immediate and direct public cost to the taxpayer of bailing out the banks has been huge, estimated at £131bn[4] in cash injections, and publicly funded guarantees of £850bn made available in the midst of the crisis.[5] The cost to the economy in lost output due to the volatility brought on by the instability in the financial sector is much greater.

The knowledge that there is an implicit government subsidy, as Professor Julian Franks told the Commission, gives banks a low ▶


LORD TURNER

BOX 2: SECURITISATION

Before the advent of securitisation, UK banks typically made loans using the deposits placed with them by consumers and businesses. It was a simple model: raise money through deposits, and then lend some of that money out. The bank took the risk that the borrower would not be able to repay, and hence was careful about who should receive a loan.

In the late 1990s, UK banks began to make increasing use of securitisation. First, they borrowed in the securities markets, in essence replacing the need to find new depositors. By 2008, UK banks had expanded their loans to over £800 billion more than their deposits.

Northern Rock was particularly active in borrowing from the securities markets. It would make loans to its customers, using the securities markets to fund them. This allowed Northern Rock to expand its loan book faster than it would have been able to if it had remained dependent on attracting savers to fund lending. At their peak, its loans were more than three times the level of its customers' deposits. This made it vulnerable to any disruption to liquidity in the wholesale banking market.

Second, particularly in the USA, securities markets were also used to sell the loans which the bank had made. Take, for example the securitisation of mortgages.

Mortgage securitisation is a transaction whereby individual mortgages are pooled together and turned into bonds (called mortgage-backed securities), which can then be bought and sold. Sometimes these mortgages were made or 'originated' by banks, sometimes by others. The key thing was that those who originated the mortgages were no longer responsible for them, they would sell them on, either to banks or to other investors. The attraction for investors is that these products offered a steady income – provided by the repayments being made by customers towards the individual mortgages each month. Furthermore, by buying a 'package' of these mortgages, the risk of default on any individual mortgage is spread, and hence, all else equal, risk would be reduced.

What went wrong?

In the run up to the credit crisis, mortgage originators increasingly used securitisation to expand lending into higher risk areas such as 'subprime'. The theory was that by dividing up the parcels of loans into different tranches, different risk profiles could be accommodated and risk could be increasingly spread through the financial system. What was forgotten was that those who originated mortgages now had little interest in ensuring that the borrower would be able to repay. Investors depended on the assessment of Credit Rating Agencies as to whether the securities they were buying were 'investment grade'. But these agencies, (who were paid by the originators of the mortgage securities), got things badly wrong. The underlying sub-prime mortgages started to default. Once this started to happen, investors lost confidence in the whole system and liquidity dried up. Banks, like Northern Rock, who depended on the securities markets to finance their operations discovered that their sources of funds had disappeared. And when depositors became aware of this they withdrew their funds.

Borrowing and lending though the securities markets had proved to have some very different characteristics from traditional banking operations. It allowed dramatic expansion in banking operations. But it meant that those issuing loans were no longer responsible for the credit worthiness of the borrower. That loss of responsibility proved to have toxic consequences.

cost of borrowing, (because those who lend to the banks know the government will bail them out if things go wrong), and so encourages banks to lend more and more.[6]

> 'If you look at some of the costs of capital reported by banks, it was lower than water companies. How can the cost of capital and risk of a bank be below that of a water company? The answer is it wasn't, but they were given these explicit and implicit guarantees, which reduced their cost of capital. This made huge incentives to increase leverage.'

The subsidy also means that creditors do not exercise sufficient external influence. The consequence of this has been that the market failed to constrain the risky behaviour of large, complex banking institutions. Mervyn King told the Commission:

> 'The real problem we have now [is] not so much that the managers of banks go in saying, how can I be reckless today? It's that the mechanism that we rely on for discipline to be imposed on those institutions…is largely coming from creditors, the providers of finance to those institutions. The bulk of the finance and the banking system is in debt form, it comes from wholesale or other suppliers of debt finance and retail depositors. But if all of these people feel that they effectively have a guarantee from the state, they have absolutely no incentive to monitor the behaviour of those institutions to which they are lending, because in essence, they probably think they're really not [exposed to] the institution but to us… The taxpayer will bail them out, and that removes one of the big disciplining elements in the way the system is supposed to operate… Ultimately, the heart of the problem does come down, in my view, to the inherent riskiness of the structure of banking that we've got, and the difficulty of making credible the threat not to bail out the system, which is what is underpinning the implicit subsidy and creating cheap funding for large banks taking risky decisions.'

The implicit government subsidy has two particularly damaging effects. It is greater for larger banks and so distorts competition by weakening the ability of small or new entrants to become serious challengers.

It also encourages banks to intertwine risky investment banking activities with essential banking services, such as the payment system and retail deposits. This means that when a bank is in danger of failing, the government has little choice but to extend support to the full spectrum of activities. The result has been that the taxpayer has provided guarantees against losses on loans, not only to small businesses and consumers, but to hedge funds based in the Cayman Islands, and portfolios of complex securities which the bank thought it would be able to trade for a profit.

For the UK, the problems are particularly serious given the relative size of the country's economy relative to the guarantees it has made. If all bank assets are guaranteed, this is five times larger than GDP.[7] Hence, the regulatory approach to managing the UK banking sector is not sustainable. As Mervyn King told the Commission:

> 'Our ability to sustain a large international financial centre, in my view, depends on demonstrating not only to the rest of the world, but to ourselves, that that centre doesn't depend on taxpayer guarantees, because if it does, we will have to reduce the size of it to a level proportionate to our ability to provide tax finance to underpin it.'[8]

Since the crisis of 2007, the banking industry has been subjected to extensive review. There have been a large number of official reports. National banking regulators have upped their game and the G20 countries have set their finance ministers, central bankers and financial regulators to work to achieve a co-ordinated response, the outcome of which will be known later in 2010.

Lord Myners, former Financial Services Secretary

'The banking industry, because it's been underwritten implicitly against failure, without paying a premium, has enjoyed a huge subsidy'

Some important steps have been taken to shore up the industry. New rules on leverage ratios and capital adequacy will increase the industry's safety margin in the short-term. But these alone will not create a healthy industry. The structure of banking remains unchanged. The regulatory framework allows competition, but not the sort of competition that will necessarily lead to benefits for customers. And the culture and ethics of banking have not been fundamentally challenged.

The Commission's fear is that the present response to the banking crisis is, by the admission of those charged with its implementation, inadequate. It has focused almost exclusively on reviewing international agreements governing the level of capital banks must hold, and giving greater prudential powers to the regulators, in particular to the FSA and the Bank of England. The Commission therefore questioned the chairman of the FSA and the Governor of the Bank as to whether, had regulators had more powers, they would have stopped the financial crisis taking place. Mervyn King used the example of Citibank. Reflecting on its management he told the Commission:

> '[They] were highly intelligent. We would have chosen them to be the best team that you could have to run a bank, that's on the executive side. Then the building itself was full of regulators, there were people living there, dozens of them regulating Citibank... None of these people managed to stop the risks materialising or things going wrong. Now I cannot believe that any regulator around the world could honestly pretend that they would do better than what happened there.'

Both Mr King and Lord Turner were adamant that such powers would not have been used by the regulator, since they, like the rest of the financial system were in the grip of a 'flawed intellectual model'.

As the great British economist Alfred Marshall[9] noted, there is always a need for honesty and uprightness amongst those who manage our money, if the financial system is to work well. This means we need to think broadly about the best structure of the banking industry. It suggests that simply strengthening the role of the regulator is unlikely to create a stable financial system; one which is fit for purpose, where competition is effective, where agents act fairly on behalf of their principals, and which is less open to capture by 'flawed intellectual models'.

The prudential regulations that are being imposed on our banking system may well prevent an identical meltdown taking place. But they do not address these fundamental issues. As Professor Hu of the University of Texas, who recently joined the US Securities and Exchange Commission, has noted, the process of innovation in financial markets aims to get around the classifications which regulators establish. So regulation imposed today may simply set in train a process whereby our banks and financial institutions simply try to find ways to maximise their own advantage within the letter, rather than the spirit, of the law.

Once the structural issues have been addressed, it will be possible to achieve a deep seated change in the industry's culture, an issue that troubled many witnesses. Chris Rhodes of Nationwide told the Commission:

> 'I think culture is incredibly important because it sets the tone ultimately for the values of the organisation... I strongly believe you cannot encapsulate everything you need to do in rules and regulations, therefore a focus on the value sets and behaviour in an organisation is... key.'

Stephen Green, chairman of HSBC, took a similar view:

> 'I think the most important lesson from this crisis is actually an old lesson and not a new one, namely that rules may well be... necessary [but] are equally clearly not sufficient. No business, certainly no banking business, can afford to do without a board-led, senior management-supported, ethical approach

MERVYN KING

HECTOR SANTS AND LORD TURNER

STEPHEN GREEN

Will Hutton, executive vice-chair, The Work Foundation

'The notion that banking is a completely private sector activity upon which we have no view as a national community, is an impossible one'

to behaviour; to understand that there is a purpose to the business that you do, which is not simply measured by short-term profitability, is profoundly important, and unless that culture is there in an organisation, no amount of rule-setting and no amount of careful compliance is going to be an adequate substitute.'

The Commission would wholeheartedly agree with these sentiments. However, as the exchange between the Commission and the chief executive and chairman of the FSA, below, indicates, regulators clearly have some difficulty in addressing the issue despite a recognition of the need for cultural change.

> COMMISSIONER Because if you don't get the culture right it's very difficult for the regulator to solve the problem?
> HECTOR SANTS Yes, so we need culture, and we need early intervention. But early intervention without cultural change won't solve it, and culture alone won't solve it....
> LORD TURNER And I think the other thing to say is... we simply don't know whether we really have tools which can help change culture.

This suggests we need a very profound change to the banking system. We need not just to place a sticking plaster on those parts of the system which are seen to have failed, but to use this opportunity to re-engineer the system.

Witnesses from the banks seemed to believe that such a change was taking place. For example, in his evidence, Stephen Green, chairman of HSBC, told us,

> 'I don't think that there's a mood in the industry that says, just let the storm blow and we can get back to business as usual. That would not be a characterisation of the mood amongst the leadership of the industry so far as I perceive it.'

Others thought the reverse. Robert Peston's evidence illustrates the point.

> 'I don't think the bankers themselves believe the world has changed in a fundamental way. When I talk about how it would be a good thing if, for example, there was a bit more simplicity in their structures and a bit less complexity in the kind of products and services they provide in wholesale markets, they look at me as though I'm completely mad.'

We need a new approach that recognises why banking is different.

Solving all this is difficult because there are several reasons why banking markets behave differently to others. We would point out three distinct characteristics. The first has to do with profit and risk. It was summed up eloquently in the evidence given to us by the late Sir Brian Pitman:

> 'One of the great differences I think between banking and other activities, is that [in banking] you can increase the profits of the outfit simply by changing the risk profile. I was chairman of Next [a retailer] at one time, and we couldn't wake up in the morning at Next and say, what we're going to do is greatly expand our business, what we're going to do is increase the risk profile. But in banking, it's perfectly possible, in the short term, to decide to be more risky than your competitors. That will get everybody to beat a path to your door, and will wind up [in the] short term with very big profits. And if you gear up the remuneration system appropriately, you can become rich quite quickly.'

Although one bank executive disagreed with Sir Brian's view, arguing that risk could equally be taken by an auto manufacturer who skimped on safety to increase short-term profits, the Commission supported Sir Brian's view that the ability to generate short-term profit from lending is qualitatively different from that in most other industries. ▸

Participant, Which? Big Banking Debate

'I'd like them to understand I have peaks and troughs…When you're doing well they're happy but they don't help when times are hard'

This is because revenue and profit can be received by banks before the costs are realised. A borrower may pay interest for a while, but it is not until they repay in full, or default, that the cost of the lending is known. It is for this reason that so much regulation centres on the prudence with which bank lending is made. It is also the reason that governance systems, such as a statutory audit, have been established to ensure bank boards are not prone to making injudicious loans, or to recognising profit before it has been earned[10].

A second feature is one which economists refer to as 'asymmetric information'. These are situations where the seller knows more about the product than the purchaser, and where the purchaser is unable to judge which seller will give them the best deal, and hence can be taken advantage of[11]. These situations occur throughout the financial services industry, and were clearly articulated in the Commission's exchanges with Gill Kirk, a former branch employee of one of our large banks, who was concerned that the incentive structures at banks encouraged the mis-selling of financial products.

> COMMISSIONER Would the customer know that [they had purchased a poor product?]
> GILL KIRK I would say that the customer wouldn't know that they'd been sold the wrong product. And when you're just in front of the customer and selling them, you wouldn't… know that the product that you've sold them wasn't the right one, because you weren't then involved in the future of that customer, you were just involved in selling the product.

Lord Turner reinforced this point:

> 'The point about the financial services [industry] is that when you buy a pension or a long-term insurance product, you are buying something which, if you don't like it, you can't simply say…a week later, I didn't really like that experience, I'll go next door. You're buying something which lives with you a long time, and you're also buying something where you will not know whether that is a good product or not for 10 or 15 years afterwards.'

The consequence, as Jeff Prestridge, personal finance editor of the Mail on Sunday, explained, is that:

> 'We are now in a situation where a lot of the banks are trying to sell products that are far too complicated, essentially to meet great profit targets… The fact is that [customers] are repeatedly being mis-sold or they are mis-buying products.'

The third feature is the fact that, throughout the banking and financial services industry, those who deposit money trust that the bank will manage it on their behalf. As the owners of the money deposited, consumers are what economists would call the 'principals'—we trust that the banks, 'our agents' will work on our behalf, and not on their own. Adam Smith noted of this relationship:[12]

> 'It cannot be expected that they will watch over it with the same anxious vigilance with which [owners] watch over their own. Negligence and profusion must always prevail…'

Relations between principal and agent can be managed by law and regulation, and the financial services industry includes many agencies whose activities are governed by trustee law, rather than by contract law, with independent expert monitoring. But principal and agent relations work best when there is a culture of trust between them.

Banking's unique characteristics make it susceptible to distortions, and witnesses told the Commission that these pervade the banking system, from the way in which contracts for credit cards are written, through to the construction of complex securities. They inhabit equally the incentives given to boards of directors and to branch staff. And unless these fundamental features are recognised and addressed, we will not have constructed an effective, safe, and secure structure for the banks of the future.

The aim of the Commission's report is not just to offer a solution to the recent banking collapse. Rather, it is to map out the path towards a sustainable culture, structure and regulatory landscape for the banking industry, which will, of course, minimise the risk of future banking failures, and will extricate the government from its current implicit role as guarantor of the industry. But the larger aim is to create a stable yet competitive banking industry, where the interests of consumers and businesses are aligned with those of banking executives and shareholders, and where banks can be allowed to fail without risking the stability of the wider economy.

BOX 3: THE WHICH? BIG BANKING DEBATE

The remit of the Future of Banking Commission was to seek to join-up the missing link in the debate over the banking crisis: the views of ordinary people and wider society.

In order to do this, Which? set up the Big Banking Debate. This was a chance for ordinary people to get involved and have a real and lasting influence on the future of the banking system. An event attended by over 300 people was held on 4 February 2010 in London, while interviews with consumers were undertaken up and down the country. Consumers were also given the chance to submit their views and stories via the Banking Commission's website.

What was clear both from the evidence of individual experts, from the views of the 300 people who came to our big banking debate, from interviews with consumers around the country, and from the wealth of written evidence we have received, is that the banking sector was not working in the best interests of consumers or smaller businesses before the onset of the crisis. The crisis itself highlighted new potential concerns such as the safety of their deposits, which may have before been taken for granted. But many problems, such as poor levels of customer service, a sales-driven culture, unfair charges and lack of transparency were raised as endemic issues which prevailed before the onset of the banking crisis.

Mapping out the solution

In this short paper, we cannot claim to have addressed in detail all the reform needed, or the issues raised by reform of the banking industry. However, we hope to stimulate a wider, ongoing debate about the role and nature of this most critical of industries. There is a concern, as the media spotlight moves on, that bankers and their regulators will tend to return to 'business as usual'. This would be a mistake, both for the industry and for the wider community it is there to serve. We note the comments of Mervyn King that:

> 'If the time horizons of the people involved in those discussions, whether they be politicians and ministers, or whether they be officials, if their time horizons are short they will find deep reluctance in pushing ahead with a debate about fundamental reform, which inevitably will take time to conclude and then to implement... My fear would be that we'll have this debate that we will set out possible alternative models for the structure of banking, but not very much will happen, there'll be a bit done here and there, but it won't actually prevent the next crisis, the next crisis will be even bigger, and at that point people will look back and say, well they had the right idea after the previous crisis, they just didn't implement it but now we will.'

In this report we will not have been comprehensive or definitive in all our recommendations. But we hope we will have stimulated an ongoing debate about the future of our financial services industry, and contributed to a civil economy which aims to improve its performance.

In this report we make 39 recommendations. Some suggest immediate action. Others, such as the drive towards cultural change, will require a longer process of change. We are not suggesting that there is a final 'perfect' model of how banks should operate. Rather we should be trying constantly to improve the performance of the industry. The mathematical models which were used to calculate risk before the crisis turned out to be precise, but wrong. Our view of the world will be much less precise but will, we hope, have the merit of being correct, albeit approximately so.

When we embarked on this work, some believed that we would have to address many questions, each needing different answers, from the mis-selling of products in bank branches, to the instability of bank leverage. In the process of taking evidence, we have been struck by the fact that our witnesses have all described similar problems: lack of effective competition, inappropriate structures, a failure of trust and of checks and balances. Therefore, rather than trying to find individual solutions for each banking market, we are purposely suggesting a broader perspective needs to be taken, where the banking industry is designed to deliver the services for which it was established. ■

Chapter two

Structure

Experience shows it is inevitable that some banks will continue to fail and that periodic systemic crises will recur. The authorities' task is to allow for these corrections but to ensure they do not put the entire economy at risk.

This is currently achieved by the unsatisfactory method of the government standing behind the banks. This implicit subsidy erodes market discipline and gives the banks a higher credit rating than they would achieve as genuine standalone businesses. It enables them to reduce their borrowing costs and run higher levels of risk and leverage in both retail and investment banking. Indeed, it encourages banks to maximise the benefit to themselves from the implicit subsidy, by intertwining highly leveraged and risky investment banking activities, with banking services such as retail deposits and the payments system, which are vital to the functioning of the economy.

By standing behind the banks, the government creates what economists describe as 'moral hazard'. Because creditors know that the money they lend to the banks is guaranteed by the government, they take less care to ensure that the bank they lend to is behaving prudently. By encouraging high and excessive leverage, the implicit subsidy actually increases the likelihood of taxpayers being forced to step in and support the banking sector.

The Commission believes that these issues require a change to the financial architecture, to limit the guarantee and create an absolutely credible and real threat of failure. Changes to the regulatory approach to banks, necessary to underpin and support these proposals, are outlined in Chapter 3. It may mean some financial services are, on the face of it, more expensive, that borrowers find it harder to get credit and that the level of trading activity in some markets may reduce. However, this must be balanced against distortions caused by unlimited taxpayer guarantees.

Resolution regimes

Resolution arrangements can make banks safer to fail. The recent Financial Services Act 2010 places a new duty on the FSA to require firms to produce Recovery and Resolution Plans (RRPs) or living wills. These are intended to form a plan on how to manage a collapse without jeopardising financial stability or requiring support from taxpayers.

The Commission is supportive of proposals for living wills as a step towards reducing the government guarantee and re-injecting market discipline by allowing banks to fail. The living will should ensure that within any banking group the core deposit and lending functions and the payments system are ring-fenced with their own separate balance sheet, liquidity and funding mechanism.

An important aspect of the living will is that it should change the behaviour of the bank and its trading partners in terms of how they price risk and how they extend credit. In order to guide their behaviour effectively, there should be a ring-fencing of the core banking activities from the non-core activities. The principle should be that the core deposit and lending functions, and the payments system, should be ring-fenced with their own separate balance sheet, liquidity and funding mechanism. These ring-fenced deposits should not be used to fund investment banking activities.

If it is to have a behavioural effect, the living will cannot simply be a private exchange between the bank and its prudential regulator. Rather, it must be a public document. ▸

Mervyn King, Governor, Bank of England

'I think that clearly one of the consequences now is that with the implicit subsidy from [being] "too important to fail"...there is an advantage to being not so much large in terms of size, but large in terms of scope. So you really want to have a big link to the payment system and retail deposits, and do a lot of other things, because then you know the government can't afford to let you go under, and that implicit subsidy clearly has value. We need to get rid of that'

Participant, Which? Big Banking Debate

'Privatising profit and socialising the losses is the summary of the financial crisis'

- In an emergency resolution situation, the living will must explicitly delineate which part of the bank is to be supported and kept solvent, effectively drawing a dotted line down the balance sheet. The resolution authority should be able to metaphorically 'tear along the dotted line', and separate the protected from the unprotected portion of the balance sheet. Precedents for this exist in the US, where the Federal Deposit Insurance Corporation has successfully wound down a large number of failed banks.

The living will must also cover how customers are going to be treated in the event of failure. Ensuring that any living will offers sufficient protection for customers' interests and the provision of essential services will be a key task for the prudential regulator which we describe in Chapter 3. It will also be the responsibility of the bank to convince the prudential regulator that their management information, information technology and internal controls are capable of executing the procedures envisaged in the living will. A formal and transparent living will should also encourage the bank's creditors to demand a simplification of both the bank's legal structure and accounts. As noted in Chapter 4, the accounts of individual banks can be opaque and difficult to understand.

Protecting deposits

As a complement to living wills, banking reform should also focus on protecting deposits. The UK has already begun to address this on a unilateral basis. Retail deposits up to £50,000 are already guaranteed under the Financial Services Compensation Scheme (FSCS). There is still more that could be done to ensure the scheme is fully transparent and understandable by consumers.

The Commission believes the £50,000 limit should be applied to each brand rather than to each licensed institution. The Regulator should also prevent the misleading promotion of products which claim to provide a guarantee of capital, but which are not covered by the compensation scheme.

There should be clear signs on all bank tills, websites and other promotional material produced by financial services firms, informing depositors how much of their deposit is insured by the FSCS.

This will prevent market entrants like Icesave marketing less securely protected accounts to customers who are not fully aware of the extent of their rights. It is intended, however, that the reform of the liquidation procedure, proposed later in this section, will reduce the likelihood that the insurance provided by the FSCS is called upon.

A new class of deposit should be created, which carries a 100% guarantee, but which should only be invested in 'safe' assets such as government bonds. This idea was put forward to the Commission by Mervyn King.

This new deposit class would allow retail investors with savings in excess of the government guarantee, risk averse high net worth individuals, homeowners temporarily placing large sums on deposit during housing transactions and SMEs to have the option of placing their deposits into safe haven accounts. Safe havens would be the only accounts to have an unlimited government guarantee.

It would be for the government to decide how the taxpayer would be protected from the risk of having its guarantee called in. This could be achieved by requiring safe haven operators to keep a large proportion of the deposits in UK government securities, by requiring them not to lend the full 100% of their deposit base, by a financial levy, or by a mixture of the three. To cope with high demand in times of crisis, an appropriate 'notice to deposit' period might be required for safe haven depositors to allow the safe haven account operators to build up the required liquidity buffers.

Banks might wish to offer other accounts, perhaps paying higher interest which would have the £50,000 protection limit, but no other government guarantee. Depositors in these accounts would need to accept that their money could be invested in risky assets with a risk of the bank going down.

Depositor protection should include reform to the bankruptcy procedures so that the rank of creditors is changed to put depositors at the top. This would have the added advantage of removing the additional protection which is currently afforded to bondholders by the belief that, since they rank in the same order as depositors, their investment will be protected. It must be clear that bondholders can lose money and will not be supported by the government.

When a bank's creditors are covered by an implicit government guarantee, they do not have the incentive to keep the bank from getting close to administration. In effect, exposing creditors to the true credit risk of banks limits the exposure of the taxpayer to financial crisis.[1] Furthermore, formal reorganisation is more costly than informal reorganisation, and both equity holders and creditors retain more of their investment under informal reorganisation. By removing the government guarantee of a bank's creditors, we can encourage informal reorganisation and limit the taxpayer's exposure to financial crisis.[2]

Should there be a formal separation of banking activities?

The living will should go a long way towards improving stability and reintroducing market discipline to the financial system, protecting depositors, and limiting the taxpayer guarantee. However, structural reform can strengthen the measures of the living will.

Universal banks contain three core businesses. These are:

- Retail banks looking after deposits and making loans to private individuals and SMEs and operating the payments system.
- Commercial banks providing balance sheet and other financial services to corporates of mid-size and above.
- Investment banks advising and acting in the capital markets for corporates, governments and financial institutions.


STEPHEN HESTER

Stephen Hester, chief executive, Royal Bank of Scotland

'What we need to do is to find a way for that (bankruptcy) to happen with banks, so that a bank can continue to provide its essential functions while you attribute the losses, and it's easy to attribute them to shareholders – we all know how to do it and that's happened. What has been difficult is then to take those losses beyond shareholders to creditors of one sort or another while having the bank function because of the vulnerability of money'

BOX 4: PRINCIPAL ARGUMENTS USED FOR STRUCTURAL REFORM

- Banks provide utility services for the economy, such as holding deposits and operating the payments system. These functions are vital parts of the national economic infrastructure and should be put in ring-fenced narrow, utility banks, separate from riskier investment banking activities.
- Unsuccessful companies should be allowed to fail. In banking, utility banks should be the only exception to this. No other bank should be so big that failure would cause systemic risk and require taxpayer support. Therefore banking conglomerates should be broken up.
- The modern global banking system has become so inter-connected that failure in one part has unpredictable, but far-reaching, consequences elsewhere. This requires the insertion of firewalls and firebreaks into the system.
- Diseconomies of scale exist in banking. There is no evidence that big banks are more efficient. Broad scale institutions are too complex to manage safely. The solution lies in smaller, simpler institutions.

STEPHEN GREEN, PAUL THURSTON

BOX 5: PRINCIPAL ARGUMENTS USED AGAINST STRUCTURAL REFORM

- Radical reform would require hard-to-achieve global agreement.
- The modern global economy has sophisticated financial needs and these can only be delivered off a broad trading and banking platform.
- Failing non-utility banks cannot be left to market forces to sort out. The US government felt obliged to engineer the rescue of Bear Stearns and havoc was wreaked when it allowed Lehman Brothers to fail. Neither Bear Stearns nor Lehman Brothers were deposit-taking banks.
- Banks specialising in a narrow range of activities are risky too. Banks specialising in retail and/or commercial banking such as Northern Rock, Washington Mutual and Indy Mac failed. These banks take the same kind of risks as each other, thus perpetuating systemic risk.
- Glass-Steagall did not work. The US experienced more banking failures than any other advanced economy including a full-blown crisis in the savings and loans sector in the 1980s.
- The financial crisis was caused by excessive leverage and inadequate capital not scope and can be addressed by less radical solutions than breaking up the banks.

DAVID PITT-WATSON

PHILIP AUGAR

Whether or not these integrated activities should be split up is widely debated and there is a striking difference in views between the top of the UK's financial services regulator and the country's central bank. Lord Turner's report described breaking up the banks as 'not feasible'. In contrast, the Governor of the Bank of England, Mervyn King told the Commission that the idea has merit, and in a powerful, recent speech Andrew Haldane, the Bank's director responsible for financial stability, said that 'banking reform may need to look beyond regulation to the underlying structure of finance'.[3]

The academic world is also divided. The Commission heard from Professor John Kay that core 'narrow banking' functions – such as payment services, lending and deposit taking – should be isolated from riskier activities. Professor Jon Danielsson, on the other hand, said 'universal banking is no riskier than narrow banking' and that 'narrow banking is a bad idea.'

The Commission takes the view that although the banking crisis was not solely caused by the combination of retail, commercial and investment banking, the progressive integration of the industry over the past two decades played a major part. We believe it to be significant that having avoided a global banking crisis during the 65-year life span of Glass-Steagall, the world stumbled into one within a decade of the Act being repealed in 1999.[4]

The reintegration of retail, commercial and investment banking symbolised a state of mind that said 'anything goes in finance'. That mindset encouraged investment bankers to gear up their own balance sheets and chase down the retail banks with new derivative products. It persuaded previously staid financial institutions – such as Northern Rock, Bradford & Bingley and HBOS – that it was safe, perhaps even expected, for them to leverage up to levels previously seen only at the most racy of investment banks. Changing that mindset means changing the structure of banking.

BOX 6: HOW A DISAGGREGATED BANK WOULD LOOK

Retail Bank
- Conventional retail and SME banking
- £50,000 guarantee per brand on all accounts
- Full government guarantee on safe haven accounts
- Operator of payments system
- Living will

Commercial Bank
- Wholesale banking
- Syndicated loans
- Treasury including currency and interest rate swaps
- Securitisation of loan book permitted with fixed proportion of 'skin' in the game
- Able to trade debt only through a trading bank

Investment Bank
- Investor sales on an agency basis
- Investor research
- Corporate advice
- Securities underwriting
- Restrictions on use of own sales and research to distribute in-house securities issues

Trading Bank
- Trading debt, equities, currency, commodities
- Trading derivatives
- Assembling and pricing structured derivatives for advisory and investment banks
- Allowed to conduct customer and proprietary trading
- Would not be allowed to give advice
- Could not be owned by an advisory bank

▶ The living will is an absolutely indespensable first step to reform the financial industry, but we need to consider structural reform as well. The commission has received powerful and persuasive evidence from expert witnesses in support of restructuring the banks. There can be no prevarication on this crucial issue since the compulsory separation of banking activities has the potential to solve many current and persistant problems. Therefore the government's new commission should consider urgently and in great detail a structural solution to the problems caused by large, integrated banks.

Structural reform should:
- Protect depositors
- Limit the taxpayer guarantee and thereby reduce moral hazard
- Impede cultural contamination of retail banking by investment banking
- Eliminate conflict of interest within banks
- Curb the 'too big to fail' problem

Any structural reform needs to be carried out carefully and in an ordered sequence with potential break points to reflect evolving circumstances. There are several natural break points upon which to disaggregate a bank, articulated in Box 6.

There are strong arguments for making a unique separation of retail banking, and for dividing the investment banking division between its advisory and trading functions. Separating retail banking would protect depositors, limit the taxpayer guarantee, and impede contamination from the investment banking culture. Splitting the trading arm of an investment bank from its client advising and securities underwriting would reduce internal conflicts of interest and curb the 'too big to fail' problem.

Participant, Which?
Big Banking Debate

'Consumer banking must be split from investment casino banking'

Separating retail from other banking businesses

A stage beyond living wills would be to require all banks operating a retail business in the UK to do so in standalone retail banks that would conduct conventional retail banking and lending


SIR MARTIN TAYLOR

and operate the payments system. This would protect depositors, and reduce the moral hazard by limiting the taxpayer guarantee. Moreover, it would halt the contamination of retail banking by the investment banking culture.

With the exception of £50,000 per brand and any money invested in these banks' safe haven accounts, depositors with these retail banks would not be guaranteed by the government but regulators would require the banks to adhere to prudent levels of capital, leverage and lending and would require them to hold a certain proportion of deposits in gilts. If the UK was to implement this without international agreement, the separation would need to be in respect of banks' UK business only.

The Commission heard opinions from Mervyn King, John Kay, Julian Franks and others in favour of the formal separation of retail from other banking businesses. Others argued that this would be unnecessary if living wills were effective since the retail bank could be detached from the universal bank in the event of the parent bank getting into difficulty.

Formal separation has advantages over living wills. Retail deposits would not risk being contaminated by high-risk investment banking. A separate retail entity with its own board of directors and shareholders and a straightforward business model should be easier to manage and to supervise. With conflict of interest much reduced, it should be possible to establish the cultural and ethical standards we advocate in our final chapter. Full separation would also reduce the not inconsiderable risk of banks being able to find ways round the rules of resolution regimes.

Standalone retail banks are not a guarantee against failure as the fate of Northern Rock showed. But with better regulation including capital and leverage rules, they would be a robust component of a new financial architecture.

Breaking up investment banks

If it were deemed necessary, isolating retail banking from other banking activities could provide a measure of protection to consumers but it does not address the wider issues of scope and scale in global banking. Solving these problems requires global agreement and discussion over the medium term but it is important to commence that discussion before the waters close over the recent crisis. We must also address conflicts of interest within investment banks.

The Commission believes that Senator Carter Glass and Representative Henry Steagall were correct to identify the co-mingling of securities trading and banking as the fault line in the 20th century banking system. That fault line has been widened by financial innovation and deregulation (including the repeal of their 1933 Act in 1999).

The dangers of this structure were forcibly articulated by Sir Martin Taylor, the former CEO of Barclays:

> 'The investment banking activities of a universal bank were at all times parasitic on the retail bank balance sheet. I used the word carefully and I wouldn't change that view now. I think there are serious dangers, and if you are going to have universal banks, you'd better be sure you regulate them very carefully and very hard… Investment banking activities, valuable though some of them are… some of them are not. And the trouble we've got into is when the non-valuable activities have been combined with an excess of leverage which has put the whole organisation at risk.'

Banks are now allowed to take deposits, provide other vanilla banking services and also to engage in investment banking. Within their investment banks, they are allowed to advise corporate and institutional clients, to trade for themselves and others, and to cross-sell a myriad of balance sheet and other

BOX 7: THE SECURITIES AND EXCHANGE COMMISSION V GOLDMAN, SACHS & CO AND FABRICE TOURRE

On the 16 April 2010, the US Securities and Exchange Commission charged Goldman Sachs & Co, and one of its employees, with fraud on complex financial products worth $1bn. Goldman and its employee have vigorously denied these allegations. Goldman is alleged to have misled investors who bought mortgage-backed securities from the bank, by not disclosing the significant involvement of a large hedge fund, Paulson & Co, which had both selected the underlying assets and taken bets against them maintaining their value.

This is a story of a conflict of interest in one of the world's largest and most prestigious investment banks. Goldman Sachs is alleged to have made money acting on both sides of a complex financial deal: structuring a product that was inevitably going to fall significantly in value, and then selling it on to unsuspecting clients. The conflict of interest arises where the same investment bank originated the deal, advised clients on both sides of the deal and subsequently entered into financial trades for those same products.

A significant concern was the apparent knowledge by Goldman's employee that the value of the mortgage-backed securities was about to tumble, despite advising clients who expected their value to increase. Fabrice Tourré has been widely quoted '...More and more leverage in the system [means] the entire system is about to crumble any moment... The only potential survivor, the fabulous Fab, standing in the middle of all these complex, highly levered, exotic trades he created, without necessarily understanding all the implications of those monstrosities!'

Whether the SEC civil case proves to be grounded or not, or criminal charges are ultimately made against Goldman, the suspicion of impropriety, in an industry that relies so heavily on 'trust' as a key commodity, will have done serious damage. The complex products, and Goldman's central role, clearly illustrates the danger of combining advice and trading in the same institution.

www.which.co.uk/banking

'The retail banks on which individuals and small businesses rely, must be kept quite separate from the speculators, merchant banks and hedge funds which themselves ought to be properly regulated and controlled'

financial products. In effect there are two related issues: the integration of traditional banks and investment banks, and the breadth of the permitted investment-banking model. Together, they produce four problems.

- Banks' scale and scope creates huge profits and very big institutions, and with this comes unquantifiable risk. If you allow banks and investment banks to engage in every kind of financial activity, don't be surprised if they grow into behemoths. Allowing the integrated model to persist guarantees the existence of system-threatening financial institutions.

- The model is so complex that effective risk measurement is not sustainable. Rising markets always create the illusion that risk has been mastered, and it takes an event such as Long Term Capital Management, a hedge fund that failed in 1998, or the banking crisis of 2007, to serve as a reality check. Among the world's leading investment banks, there's scarcely one that hasn't faced its moment of crisis, and as the financial services industry grows, the stakes and price of failure get bigger.

- Their breadth of activity gives the banks so much knowledge that it is difficult for the market to operate fairly. Every line of market-related business flows through their dealing rooms. They are giant information exchanges with global reach and multi-product inventories. They have their fingers on the pulse of market movements as they happen, tracking price formation and customer flows. Universal banks and integrated investment banks use this to their unfair advantage. Their superior market knowledge stacks the odds in their favour, giving them an edge over other market users. [5]

- There is an irreconcilable conflict of interest in advising clients on both sides of a deal. Trading in the market adds to the conflict. This means that the industry cannot achieve a solid ethical platform under the existing structure. Recent allegations against Goldman Sachs illustrate the issue. The clients' interests might be said to come first, but which client takes priority? Conflict of interest also jeopardises a fair market and is at the heart of many of the industry's problems. It surfaced in 2000-2001 in the dotcom crisis when the leading investment banks were exposed as having shamelessly promoted worthless internet stocks to investment clients in order to benefit corporate clients. The Enron scandal is another example of investment banks and auditors being incentivised to turn a blind eye to corporate malpractice. It distorts the takeover market because Chinese walls do not work and information leaks. We note that the FSA has just reported that over a quarter of UK bids are accompanied by suspicious movements in the share prices of the companies involved.

The Obama administration has tried to address some of these problems by the proposed Volcker rule, which would restrict banks' proprietary trading. The Commission believes this to be difficult to implement, because the line between proprietary trading and customer market making is difficult to define. Banks would be able to comply with the letter of a law forbidding proprietary trading by disbanding specialist units, but would still be able to take proprietary views from within customer market making. Thus the Volcker Rule would do little to minimise risk, and might actually increase the risk of banks using knowledge of customer behaviour to their own advantage, by placing proprietary and customer traders alongside each other.

Antony Jenkins, chief executive of global retail banking, Barclays

'We're committed to the universal banking model. We believe that is a superior model in terms of meeting the needs of our customers, our shareholders and broader society. We think that the universal banking model actually allows us to manage risk more effectively given that there is asymmetry between different parts of the banking sector'

ANTONY JENKINS

- Extending the Volcker rule to prohibit banks that advise clients from trading any form of securities, and separating corporate advice from investor advice would address many of the problems that integrated banks create.

How would structural change of investment banks work?

The Commission believes that simple rules work better than complex regulations. As Andrew Haldane has pointed out, the Glass-Steagall Act was only 17 pages long and lasted for decades; the Basel banking accords comprised thousands of pages and were overwhelmed within a few years.[6] A rule to prohibit banks that advise clients from trading any form of securities, and separating corporate advice from investor advice would be relatively simple to define. Such a rule would address conflicts of interest within the investment bank, and mitigate the problem of too big to fail.

The components of a typical universal bank were shown in Box 6 and various combinations are possible. The most radical and purest structure would require universal banks such as Barclays, and integrated investment banks such as Goldman Sachs, to spin off the trading part of their investment banking activities. These new standalone units would be able to do customer and proprietary trading in stocks, bonds, commodities, currency and their derivatives, using all modern methods of electronic trading. But they would not be allowed to advise investors or corporate clients, a role that would fall to the banks' and investment banks' residual investment banking arms.

Non-trading advisory banks would be able to advise their clients and would have their own balance sheets to commit as loans. They would be required to keep a high proportion of originated debt on their balance sheet and to pass securitised debt on to the trading banks (but not trade themselves). They would be subject to emerging G20 and Basel rules on leverage ratios and capital adequacy. They would be able to retain their traditional treasury functions in currency and interest rate trading. Crucially, however, they would not be taking market making or proprietary positions in securities on their own balance sheets, Will Hutton, executive vice-chair, The Work Foundation

'I don't think that there's evidence that large financial institutions are particularly great at assessing risk or doing good lending or have a clear idea actually of what their business purpose is'

but would have to arrange securities deals for clients as agents. In investment business, they would have their own research and sales teams to advise clients. Corporate finance departments would be able to advise corporates, and to underwrite securities, but in order to minimise the conflict of interest from advising issuers and investors, they would need to appoint third party brokers to distribute deals.

What would this structural change achieve?

The Commission does not believe that there is a magic bullet solution to the banking crisis, but this reform, together with the regulatory changes discussed later in this report, would have a significant impact on the 'too big to fail' problem. Removing trading from banks' balance sheets would remove a major source of instability. The new trading institutions would be large but they would be much less connected to the rest of the banking system. They would be transparent businesses, and it would be for their shareholders or partners to decide how much risk to run. Banks would need to be given time to restructure – three years might be an appropriate period – and the reforms would need to be underpinned by the necessary regulatory response.

Separating the functions in this way would free up the market to operate properly. It would increase the transparency of prices and profits, and remove the informational advantage that lies with the integrated investment banks. More money would stick with the end investor, and portfolio performance might improve if everyone had equal information about the market.

Without the ability to cross-subsidise, the power of the big firms would be reduced, and new entrants would find it easier to break in, thus widening customer choice and breaking the oligopoly. Reducing the power of the investment banks would change the balance between customer and banker, and make customers more likely to challenge pricing and resist bankers' transaction-oriented advice. Conflict of interest, the root cause of the informational asymmetries and cultural problems discussed elsewhere in this report, would be reduced and in some business areas eliminated entirely. This would create an environment in ▶

PETER VICARY-SMITH

which the cultural and governance reforms, proposed later in this report, might actually stick.

Breaking up the banks would be a major recasting of the global financial system. But it would eliminate conflicts of interest from most parts of the banking system and would contribute to a safer system by reducing the scale of individual banks. It would require global consensus and co-ordination but the UK is one of the world's leading financial centres and we encourage the UK government to initiate global debate on this issue.

Securities and derivatives trading

The previous sections in this chapter present resolution procedures to reintroduce market discipline. They also discuss structural changes to address conflicts of interest within banks and banks that are in danger of becoming 'too big to fail'. In Chapter 1, we noted the growth of securities and derivatives markets as alternative mechanisms for raising funds and defraying risks. Just like the banks, these markets can themselves create instability and contribute to systemic risk. Hence, they need an effective architecture and regulation.

In this section, we cannot hope to do justice to all the issues surrounding reform of securities regulation. However, we would note that many aspects of securities markets do not conform to rules one would expect to find in effective markets. This is particularly concerning when some securities can motivate their owners to do harm to the economic system, in order to reap financial gain.

Further, as AIG demonstrated, securities and derivatives markets can be open to the same systemic problems as the banks, and protections need to be in place to avoid this. Therefore, we would advocate reform in two areas; first that markets are open and transparent; second, that those trading securities and derivatives are fully capitalised against unforeseen events.

As regards the first issue, we need to create transparency about the size and nature of traded securities and derivatives.

The Commission proposes that all securities above a certain size shall only be tradable if they are registered on a system such as the Stock Exchange Daily Official List (SEDOL). This would mean that every security's basic characteristics were known and that the size of the market was calculable. It would also mean the owners of the security were potentially traceable.

The Commission would also require that investors, speculators and traders should have to disclose material positions in a company, no matter whether these positions are held as stock, options or other derivatives, or whether these positions are short or long.

VINCE CABLE AND JOHN MCFALL

Such a regulation would simply bring the derivative markets into line with the rules which already exist in equity markets. This transparency would go a long way to ensuring the intent of any investor was known, and that it was not easy for them to abuse their position, without it being apparent both to the market and the regulator.

With these reforms in place, it will be possible to see what securities and derivatives are in issue, who owns them, and whether the owners are using their position to destabilise a company, or markets more generally. At present, somewhat astonishingly, none of these pieces of information are in the public domain. In the event that such disclosure reveals that abuse is widespread, further action may be merited.

The Commission would also advocate a full review of the derivatives market, to ensure derivative transactions do not trigger systemic problems. The primary contributor to systemic risk is counterparty risk, or the risk that that the counterparty in a transaction might default on its future obligations. Over-the-Counter markets have created a complex web of trades that are impossible to disentangle in a timely fashion should a major bank, such as Lehman Brothers, collapse. The financial paralysis that ensues is devastating for the global economy.

Here is how investor Warren Buffet put it:

> 'The macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, lie in the hands of relatively few derivatives dealers...The troubles of one could quickly infect the other'.

He went on to add that when one finishes

> '...reading the long footnotes detailing the derivatives trading of major banks, the only thing we understand is that we don't understand how much risk the institution is running...Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal'.

The Commission recommends there be a thorough review of margin requirements and of all derivatives trades, whether these be undertaken through exchange trading or central counterparty clearing.

The Commission would also recommend that the price and volume of all securities and derivatives trades should be known when the trade takes place.

The Commission notes the growth of off-market trading in equities and other securities, and the existence of 'dark pools' of supply, and find it difficult to believe that these add to the stability of the market. Again, the Commission would recommend a thorough and ongoing review of these developing practices.

Ideally, all these reforms would be helped by the establishment of standardised derivatives, traded on official transparent markets. The Commission suggests that higher capital requirements for off-exchange products would provide an incentive to originate contracts on the exchange. It has been suggested that not all OTC products are suitable for exchange trading. Estimates are that 75 – 80% of all OTC derivatives by value could be moved onto an exchange with standardised contracts, but 25% are too bespoke for an exchange.

The Commission recognises many of these reforms require global agreement. However, some could be implemented on a national basis. For example, it should be possible to demand that investors in British companies declare their full position, rather than simply their equity position. Indeed, it would be a considerable competitive advantage if London were to offer a safe haven for companies which did not wish to be subject to potential destabilisation by anonymous trades in securities and derivatives. ■

BOX 8: DERIVATIVES

One of the key features of the development of financial markets during the build up to the credit crisis in 2007 was the explosive growth in the trading of financial derivatives. It has been estimated that the total market value of derivatives in existence is as much as €457 trillion, more than the total value of global GDP.[7] Derivatives differ from conventional financial assets in that they are not themselves real or tangible. Instead, they are 'derived' from a real underlying asset and are used to hedge risk or provide a vehicle for speculation.
Three common types of derivative are:

- **Futures** – These are contracts to buy or sell an asset at a future date at a fixed price agreed up front.
- **Swaps** – These are contracts to exchange cash at a future date based on the variable price of another asset such as a commodity or currency. You can also swap two series of future cash flows, such as a series of fixed interest rate payments and a series of variable interest rate payments. This type of transaction can expose organisations to unforeseen risk as the example of Saint Etienne, described below, shows.
- **Options** – These are contracts that give the owner the right (as opposed to a requirement) to buy (a 'call') or sell (a 'put') an asset at a pre-arranged price.

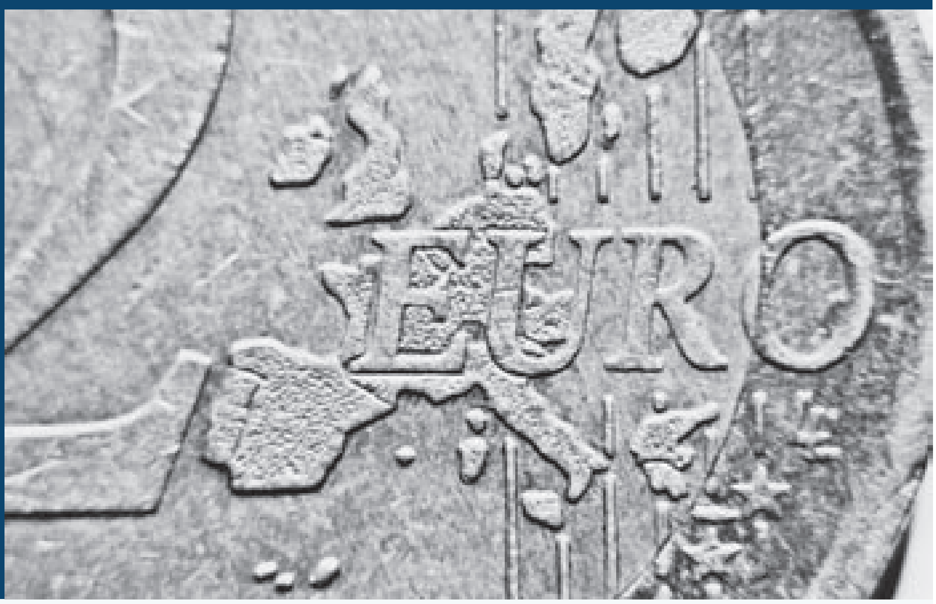
There are two main parts to the derivatives market. There are derivative products that are standardised and traded through central exchanges and then there are products that are traded bilaterally off-exchange, also known as Over the Counter (OTC).

OTC derivatives often evolve to allow clients to meet their own niche requirements. So, for example, an airline might wish to hedge its exposure to market risks such as fuel prices or changes in exchange rates, and there may not be standardised products in existence that meet their specific needs

While derivative trades are not necessarily damaging, there have been a number of spectacular failures during the financial crisis. The most notable was the failure of the giant American insurer AIG, as a result of selling a specific type of OTC derivative called a Credit Default Swap (CDS), which is effectively an insurance policy to cover against the failure of various types of bond.

Case Study - Saint Etienne

In 2001, the city of Saint Etienne in France borrowed €22m at a fixed rate of 4.9% to consolidate numerous loans that it had taken out to pay for civic projects. However, between 2005 and 2008, the city attempted to reduce its interest rate by converting these loans to 'swaps', signing a number that related future payments to movements in exchange rates between the Swiss franc and a number of other currencies and changes in long-term interest rates. At first these deals had the effect of reducing the interest bill, and in 2009 the effective interest rate fell to 4.3%. In 2010, however, one of the deals went sour as the British pound fell sharply in value. A 21% fall in the value of the pound against the Swiss franc meant the effective interest rate suddenly shot up and on 1st April Saint Etienne received a quarterly interest bill for €1.18m (effectively a 24% annual interest rate).
Cédric Grail, Saint-Etienne's current municipal finance director was quoted as saying 'It's a joke that we're in markets like this... We're playing the dollar against the Swiss franc until 2042'.



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Chapter three
Regulation and competition

Overall approach

This chapter addresses two distinct issues, both of which existed before the financial crisis arose and, unless significant change in regulatory approach is adopted, will remain long after the crisis is resolved.

The first issue is the lack of effective competition in financial services. Regulation is failing consumers, by presiding over a system where complaints about banks are increasing, and significant criticism has been made that product choice, suitability and selling practices operate against consumers' interests. This is partly because financial markets are frequently not nearly as competitive as they could be. In an effective market, providers compete with each other to sell their products. Competition means that a provider with a poorer quality, or inappropriately priced product, will lose out to other suppliers. Importantly, a key attribute of an efficient competitive market is that unsuccessful firms face a real possibility of failing. The weakness of effective competition means that financial providers often do not act in customers' interests, and the current approach to regulation has not addressed this.

Second, current regulatory arrangements do not allow financial institutions to fail without serious consequences for the economy. If institutions can't fail, then market discipline – an essential element of competition – can not be brought to bear on the incentives and conduct of financial institutions. However, banks provide essential services as described in Chapter 1 of this report. Therefore, in many cases, governments have needed to ensure banks survive, effectively providing a government guarantee to protect the financial system as a whole.

This naturally affects the incentives for banks to take on risk, and for their creditors to allow them to do so: they benefit from the upside and do not suffer on the downside. Instead, taxpayers pick up the bill. Changing this approach, so that institutions can fail while preserving the essential services they provide to society, including deposits and the payments system, is an essential component of ensuring competitive markets and financial stability in the future.

The Commission considers that neither issue can be resolved by the current regulatory regime. The way the financial services sector is regulated in the UK today fails the consumer, and is not up to the tasks of preventing future crises and maintaining the stability of our financial system.

The Commission concludes that the assumption of ever greater powers by the regulator to control process has allowed the banks to pass on responsibility for their conduct to the regulatory authorities. This has led to banks complying with the letter of the regulations, but has not delivered the beneficial outcomes essential to society. Regulators cannot replace the rigours of effective market discipline. Fundamental reform is required.

There should be a significantly different approach to regulating banks, to ensure there is enhanced competitive protection for the consumer, and that the stability of the financial system is maintained, without putting taxpayers at risk.

In practical terms, this entails splitting regulation of the financial sector into three distinct functions, each with a different remit:

1 Consumer protection regulation. At present, the focus of consumer protection is to control the process by which products are developed and sold. This approach will never be sufficient to protect the interests of the consumer if effective competition is absent from the relevant financial market sector. In the absence of a competitive market, there is no fundamental incentive for a financial firm to provide the products or service that its customers want, or to reduce its prices. To safeguard the interests of consumers, consumer protection regulation would have, first and foremost, a primary duty to promote effective competition, in order to ensure competition provides market discipline where possible. Where it is not possible, the regulator would intervene so as to mimic the effects of competition. Examples of specific measures that consumer protection regulation could employ are set out below.

DAVID DAVIS

2 Prudential regulation. At present, the approach to prudential regulation has been to prevent any institution from failing, by regulating specific capital buffers, or in the case of crises, managing the takeover of one bank by another. The regulator has, in effect, taken on responsibility for the financial probity of individual banks. The regulator must change its approach from attempting to prevent failure to ensuring banks can fail, but without significant harm to vital banking services. This will pass the responsibility for the 'safety' of the banks back to where it belongs, with the boards of the banks themselves. The measures that a prudential regulator should take are set out below and are aimed at ensuring:

- a. On the failure of a bank:
  - (i) Customer money in basic deposit accounts is protected, ranking in priority on dissolution above all other creditors, including bondholders in particular;
  - (ii) Essential retail banking services are maintained; and
  - (iii) Creditors can be identified and their positions resolved quickly;
- b. There will continue to be minimum regulatory capital requirements which a bank must meet. However these will cease to be the principal measure of the solvency of an individual bank. It is the board of the bank itself which will be responsible for determining the appropriate and safe level of reserves above the minimum requirements.
- c. The regulator will be able to intervene to restructure any institution whose failure would create a significant systemic risk.

3 Systemic risk regulation, to watch over the financial sector as a whole, in particular by:

- a. Setting capital standards by reference to market conditions current at that time; and
- b. monitoring to ensure that market innovation and behaviour are not creating a greater risk of contagion in the event of the failure of an individual institution.

BOX 9: PAYMENT PROTECTION INSURANCE MIS-SELLING

The mis-selling of Payment Protection Insurance (PPI) is an example of how a poorly functioning market, and a failure to intervene at an early stage to fix it, can disadvantage customers.

PPI is designed to cover your debt repayments if you can't work – for example, you become ill or have an accident, or you are made redundant. It is sold alongside loans, mortgages, credit cards and store cards. In the past decade, PPI has been subject to widespread mis-selling, and this has resulted in millions of consumers holding expensive insurance they would never be able to claim on.

PPI offers a clear example of a poorly functioning competitive market, as the sale of this product involved: (a) lack of adequate disclosure to customers about the product they were buying, and the resulting asymmetry of information between provider and customer; (b) inappropriate default settings, where it was left to the customer to opt out of buying the product when purchasing another financial product; and (c) the existence of inappropriate commission structures, which focused the rewards for salespeople on selling PPI, rather than serving the customer well.

The resolution of the problems in PPI has taken a long time. An initial 'super-complaint' by Citizens Advice was made in September 2005 to the Office of Fair Trading (OFT).

The OFT followed up this complaint with a market study, launched in April 2006, which subsequently led to a market investigation reference, in February 2007, to the Competition Commission (CC). In 2009, the CC ruled it would be banning the sale of PPI alongside credit products, stipulating that lenders and credit card providers would have to wait at least seven days before approaching a customer about the sale of PPI. Following an unsuccessful appeal by the banking industry, the CC provisionally confirmed this ruling in May 2010, and will be publishing its final remedies in July 2010, almost five years after the issue was first raised by Citizens Advice.

Will Hutton, executive vice-chair, The Work Foundation

'We don't, actually, as a national community, take competition seriously, we really don't... We don't understand the dynamic gains of competitive markets and we too quickly listen to big players saying there are great benefits from consolidation'

- Changes to the way in which regulation is performed will take time to implement. Some changes could be made immediately; others require legislative support.

For example, for customers to be certain of protection, and to ensure that other considerations will not prevail, it is essential to change the statutory objectives so that the promotion of competition is made the primary duty.

The Commission believes that this change of regulatory approach, along with the more detailed proposals set out in the body of this chapter, will generate substantial benefits for consumers, taxpayers and society as a whole by exposing the banks to the rigours of effective competition and the real possibility of failure without a need to rely on taxpayer-funded bailouts in the long run.

Consumer protection regulation

The role of competition in financial services markets

To date, the focus of consumer protection in UK financial services, and elsewhere around the world, has been to control the process by which products are sold. For example, to improve consumers' understanding of the products they are sold, regulators have demanded greater disclosure. However, the result has not been a clearer understanding by consumers; rather it has been the production of vast piles of small print. Elizabeth Warren of Harvard Law School has noted that in 1980, the terms and conditions of a credit card were written in 700 words.[1] Today, it takes 30 pages.

In a similar manner, the FSA's approach in the UK has focused on the 'conduct of business' of regulated firms, with detailed rules contained in its handbook. The FSA Handbook sets out specific obligations on firms, for example, prescribing the type and form of information disclosure that must be provided to consumers. The volume of 'regulatory' information is often significant. We are concerned that this may often deter consumers from using information.

Also, like the US case, it leads to a 'tick-box' approach to regulatory compliance. The danger with such an approach is not just that it is costly to implement. It is that it invites ways for market participants to meet the letter, but often not the spirit, of the law. The spirit of such a law should be that financial services markets should be designed to deliver benefits in the same way that would be found in most other industries. That means regulators need to focus on ensuring competition is effective in protecting and benefitting consumers.

The Commission believes that, at present, the lack of effective competition means consumers have not been sufficiently protected from the market failures that so frequently arise in banking and financial services markets. Certain processes for the provision of banking services need to be determined by the regulator. But the best protection for the consumer is that they can easily compare banks' products and services, and take their business elsewhere if prompted by a better offer or worsening service from their current bank. For that to happen, meaningful choice must be made available.

This is not to say there has been no competition in financial services. In fact, there is a high degree of rivalry in financial services. It is the nature of competition in the industry which has not been effective. This is not a new insight. It has been observed in the Cruickshank Report, the Northern Ireland banks market investigation, Small and Medium Enterprise banking services, personal current accounts market study, and the mis-selling of PPI.

Developments in the competitive landscape of retail and SME banking

The last decade has seen enormous consolidation in the UK retail banking industry, primarily through widespread merger activity brought on by the weakness of many UK retail banks and building societies exposed to the financial crisis.

The statistics speak for themselves. Since the Cruickshank review in 2000, the 'big four' (being Lloyds-TSB, Natwest (now RBS), Barclays and HSBC) have increased their market share in: personal current accounts, from 68% (2000) to 71% (2009) (with Santander occupying a further 12% of this market); deposit savings accounts, from 19% (2000) to 59% (2008); and mortgages, from 17% (2000) to 67% (2009).[2] The 'big four' continue to dominate, albeit that Santander has become more significant following a series of mergers leading to a 'big five'. It is notable that all demutualised building societies have seen their businesses fail, and have either been either taken over by traditional banks or nationalised.

Market shares of retail banking markets

The market share for three key retail banking services, personal current accounts, savings and mortgages are summarised on p42.[3] The most recent market shares are compared against data from 2006 as well as against figures from the Cruickshank report, which was published in 2000. The 'big four' banks continue to dominate retail banking (Lloyds TSB, Natwest (now RBS), Barclays and HSBC), and every market has become more concentrated–significantly so for savings and mortgage products. A significant new development is the emergence of Santander as a major player in all these key markets.

Small and medium-sized enterprises (SME) have also suffered from significant weaknesses in the competitive environment. In 2000, the Cruickshank report into competition in the UK banking sector found little effective competition in the supply of banking services to SMEs, leading to excess profits for banks. Cruickshank's policy recommendation was for a Competition Commission investigation into the SME banking sector.

The subsequent Competition Commission inquiry concluded that a complex monopoly existed in the SME banking sector. Subsequent to this, the main UK banks agreed to a behavioural undertaking to improve the conditions for switching and interim measures such as interest on positive balances (of no less than 2.5% below base rate) or free payment services[4] (such as direct debits and cash transfers).

A 2007 progress report by the Office of Fair Trading[5] found some improvements in competition in the SME sector: smaller banks had increased their share of the SME market; SMEs were more likely to 'consider' changing their bank (switching); more SMEs were banking with more than one provider; and internet banking usage was increasing among SMEs.

While the OFT lifted the undertaking related to payment of interest in 2007, it pointed to a number of issues still outstanding that inhibited effective competition. These included persistently low levels of switching; an inability for SME owners to easily compare the costs of banking services; and a lack of confidence in the benefits and process of switching.

In recent times, the market for SME banking services has remained concentrated, with four banks (Barclays, HSBC, Lloyds TSB and the Royal Bank of Scotland) between them having a market share of 83%.

The financial crisis has further weakened competition. The Commission heard evidence that SMEs have found it much more difficult to obtain credit, particularly relative to larger firms. The evidence provided to the Commission has suggested that the difficulties faced by SMEs have manifested themselves through higher costs, problems in getting credit extended, and sudden and 'unfair' changes to terms of contracts, such as the withdrawal of overdraft facilities.

These events have led to a loss of confidence in the banks. In particular, the representatives of SMEs suggested that more needed to be done to facilitate switching, to help remedy this type of situation, as well as to aid a general de-bureaucratisation of the whole banking process.

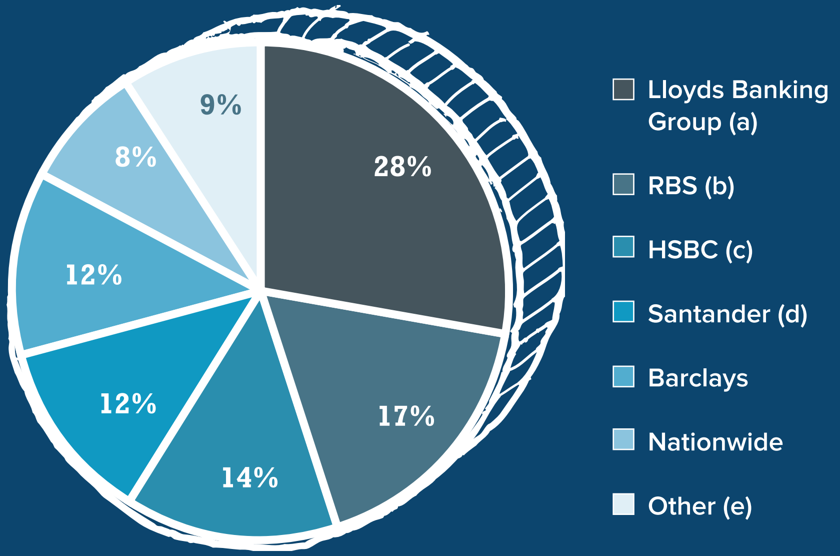
BOX 10: MARKET SHARES OF RETAIL BANKING MARKETS

Personal current accounts 2009

2009: The four largest banks supplied 71% of the market. This excludes Santander, which only became a significant bank following recent mergers.

2006: The 'big four' banks accounted for 66% of the market share.

Cruickshank review: The 'big four' banks account for 68% of the market.

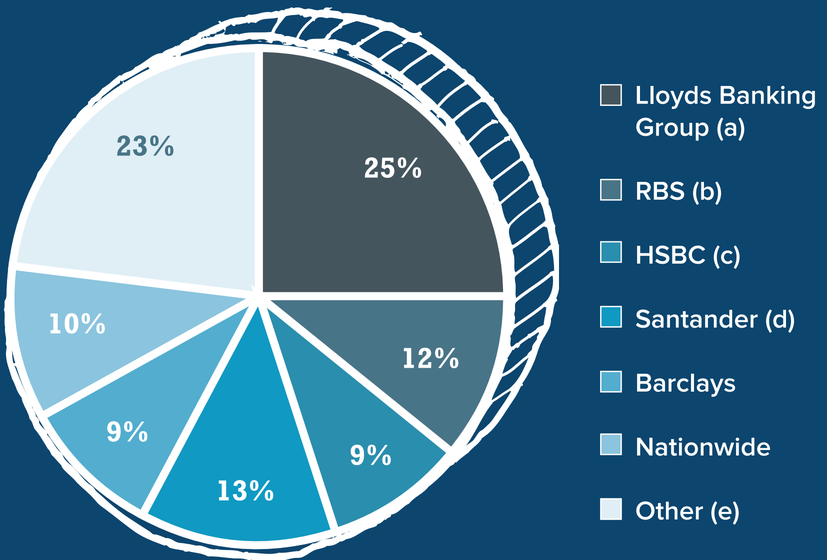


Deposit savings accounts 2008

2008: The four largest banks supplied 59% of the market.

2006: The 'big four' banks accounted for 44% of the market share.

Cruickshank review: The 'big four' banks accounted for 19% of the market. Demutualised building societies held 42%.

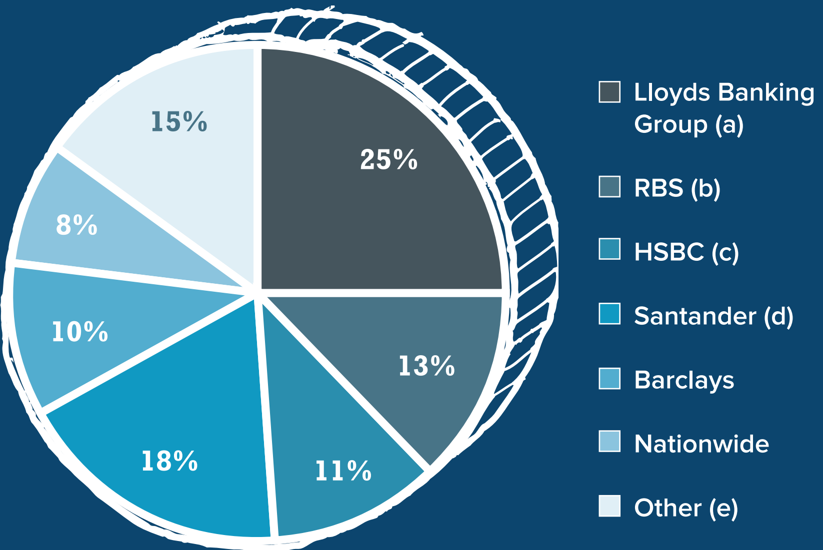


Mortgages 2009

2009: The four largest banks supplied 67% of the market.

2006: The 'big four' banks accounted for 47% of the market.

Cruickshank review: The 'big four' banks accounted for 17% of the market. Demutualised building societies held 48%.



(a) Lloyds TSB, Halifax and Bank of Scotland; (b) Royal Bank of Scotland, Natwest; (c) HSBC, First Direct; (d) Abbey, Alliance and Leicester, Bradford and Bingley; (e) Other includes survey respondents that don't know which institution provides their service.

The Commission believes that helping customers to easily switch products is paramount to the effective operation of competitive markets: markets do not function without customers who vote with their feet. As Dr Adam Marshall of the British Chambers of Commerce told the Commission:

> 'There's lots of products and services on the market, but the theoretical competition between those products and services is limited by the real world barriers of form filling, hassle, bureaucracy, decisions not being taken, etc...'

Principal functions of consumer protection regulation

The regulator responsible for consumer protection regulation should have both: (a) an explicit mandate to promote effective competition in markets in the financial sector; and (b) the necessary powers to regulate the sector to achieve this, including the ability to apply specific licence conditions to banks and exercise competition and consumer protection legislation. These powers will be concurrent with the competition powers of the OFT, and will enable the regulator to both enforce competition law and make market investigation references to the Competition Commission.

The aim of consumer protection regulation is to promote the conditions under which effective competition can flourish as far as possible, and where not, the regulator will be able to take direct action.

In order best to promote the interests of the consumer, the regulator will encourage financial firms to compete:

1 On the merit of the quality and price of their products and services; and

2 To gain a competitive advantage by investment in innovation, technology, operational efficiency, superior products, superior service, due diligence, human capital, and offering better information to customers.

Chris Rhodes, group product and marketing director, Nationwide Building Society

'I would say that no single [banking] model is the panacea. What I would advocate is a diversity of models to provide consumer choice'

The regulator would step in whenever there is a sign of market failure. Market failures include: (a) poor quality information being disclosed to consumers when they are deciding whether to purchase products; (b) information asymmetry between the provider and the consumer; or (c) providers taking advantage of typical consumer behaviour such as the tendency evident in retail customers to select the default option offered, and reluctance to switch products because of inertia.[6] Any sign of market failure indicates that competition is probably not effective, and the regulator should then take action to counteract the failure.

We are in favour of exploring further a number of specific measures that could be taken by a regulator with a dedicated remit for consumer protection:

1 Ensure customers can easily transfer products and accounts. This will significantly reduce barriers to entry for new market entrants, and may help tackle consumer inertia. The regulator could consider the introduction of a portable bank account number for personal accounts.

2 Ensure customers with overdrafts are not overcharged. This will ensure customers are treated fairly and reduce barriers for new market entrants.

3 Set 'default' settings on services, products and accounts in the customer's best interest. As Cass Sunstein and Richard Thaler point out persuasively in Nudge, customers tend to elect the default setting that they are offered, rather than make a decision about what they actually want. The consumer protection regulator would have the power to set default settings on services, products or accounts in the customer's best interest.

4 Allow customers to choose to 'opt-in' to unauthorised overdrafts. Customers who do not opt in may have some payments refused. Customers would therefore be made aware of the potential cost and inconvenience of these refusals resulting from not having an overdraft facility.

5 Ensure banks do not take advantage of existing customers. In the retail savings market, for example, consumer inertia often leads to a reluctance to switch accounts and providers. Currently, some providers take advantage of this inertia, by only offering their best deals to new customers, and denying existing customers access to newer versions of their existing products, which may have more favourable terms.

6 Act to prevent obscure charges or unfair, asymmetrical contract terms where these are present in financial products and services.

7 Ensure full and transparent disclosure on all products. For example, any fund, such as a with-profits fund, should have full annual reports showing how the funds have performed, and how much money has been spent on commissions and management fees. Generally, it should be assumed that information should be placed in the public domain unless there are strong reasons for it not to be disclosed.

8 Consider introducing standard products for some basic services which all retail providers have to provide, and a common form in plain English to explain the key terms so that customers can easily compare products provided by different providers on the same basis. Additional comparative information can also be supplied on customers' use of banking products–for example, through provision of an annual summary of charges, interest forgone and average balances in standardised format.

9 Empower customers to seek compensation via a collective redress process. The regulator should allow simple and effective collective redress to empower retail and SME customers who have suffered widespread failures of financial products or sales processes to seek compensation when serious and systemic harm has arisen. This process would allow representative bodies to act on behalf of many customers adversely affected by the same or similar issues, with examples being financial products or services which are (a) mis-sold, (b) sold under misleading pretences or (c) subject to unfair terms. The Commission advocates that the process should be on an 'opt-out' basis, which would allow representative bodies to take action on behalf of all consumers affected. Previous cases such as Payment Protection Insurance and mortgage endowment mis-selling would have qualified for collective actions.

10 Promote bank retail depositors to rank ahead of all other creditors, including bondholders. This will facilitate governments allowing institutions to fail, reducing the risk to taxpayers and forcing management to face the full consequences of their risk-taking.

11 Ensure consumer deposit accounts clearly highlight whether or not they are covered by the Financial Services Compensation Scheme (FSCS). This will prevent market entrants like Icesave marketing less securely protected accounts to customers who are not fully aware of the extent of their rights. It is intended, however, that the reform of the liquidation preference, mentioned above, will reduce the likelihood that the insurance provided by the FSCS is called upon.

12 Prohibit those commission structures which incentivise mis-selling.

13 Firewall conflicts of interest, and if the conflicts are intractable, force structural change to address the problem. Particular attention would be paid to conflicts of interest between the financial institution and its customers.

The Office of Fair Trading (OFT) is the main competition regulator for financial services. However, the OFT's role, other than in relation to mergers, is essentially to adjudicate after there has been a claim of abuse. So while it may be suited to 'repairing' previously competitive markets, it is not up to the proactive task of regulating vigilantly to make markets in the financial sector more competitive.

Helen Weir, group executive director of retail banking, Lloyds Banking Group

'I think... [there is] potentially [a need for] simpler products in the system as a whole, because the simpler a product is, the easier it is to understand. I also think though that alongside that, improved financial literacy is very important, because a lot of banking products are relatively simple at their core, yet sometimes customers don't have a full understanding of the product'

Participant, Which? Big Banking Debate

'People can only take financial responsibility if they have financial knowledge. With more widespread financial knowledge, the banking system will have to adapt and begin to be more transparent'

HELEN WEIR

BOX 11: SHORTCOMINGS OF COMPETITION REGULATION UNDER THE FINANCIAL SERVICES AND MARKETS ACT 2000 (FSMA)

The Commission believes that competition regulation under FSMA is, at best, wholly inadequate and, at worst, detrimental to the competitive landscape in the financial sector.

The ambit of the FSA is currently centred on the maintenance of market confidence, raising public awareness, the protection of consumers and the reduction of financial crime. While the FSA also has, among its primary duties set out in FSMA, the requirement to have regard to 'the desirability of facilitating competition between those who are subject to any form of regulation by the Authority'[7], FSMA does not give the FSA concurrent competition powers with the OFT, which would allow it to either (a) directly apply competition law or (b) refer markets to the Competition Commission, as is the case for the regulators of other industries.

Indeed, in its composition, FSMA gives the impression to market participants in the financial sector that they have a degree of immunity from UK competition law since agreements or conduct by a dominant firm, which would usually breach competition rules, are not subject to enforcement if 'encouraged by any of the Authority's regulating provisions'.[8]

This provision of FSMA effectively puts the maintenance of effective competitive markets in the financial sector subordinate to FSA regulation, albeit that European competition law can be applied regardless of this exclusion. Competition law considerations were further disregarded when, in the course of the financial crises, the public interest test for merger regulations was widened to include 'financial stability', allowing the Secretary of State to rule in the case of bank mergers, rather than the OFT or the Competition Commission.

The Commission is concerned that this might be seen to send a message to both the regulator and industry that competition law does not apply in the same way as it is applied to other sectors. The Commission believes the establishment of a consumer protection regulator with pro-competitive powers is of paramount importance to remedying this.

The OFT's approach was evident to the Commission in its response to consolidation in the banking industry. As Philip Collins told us:

'At the moment, we feel that the right thing to do is to actually monitor the markets, see the extent to which these changes bring about a fundamental reassessment by the banks about the way they behave and the way they treat their customers and the products they offer them.'

The FSA, under its current powers, could take some steps to promote competition. However, it is clear it does not consider pro-competitive measures to fall into its remit. Instead, these are matters for the OFT and Competition Commission. Likewise, the OFT, in its evidence to the Commission, made clear that it considers regulation of banking markets to be a limited part of its function.

The Commission is concerned that, despite efforts between the regulators to work closely together, significant actions to promote competition have not materialised. Although it is arguable that the FSA could take such action under FSMA 2000, it is clear that customers would benefit from an explicit competition mandate for the regulator, to ensure it does indeed use these tools to protect consumers.

The proposed pro-competitive objective and related regulatory powers are already common to economic regulators operating in other industries. Further, the concept of an economic regulator for financial services is not a new idea. The Cruickshank report proposed in 2000 that the FSA should have a pro-competition objective[9]. Subsequently, the Association of British Insurers noted in evidence before the House of Lords in 2007:

'Unlike the economic regulators, the FSA does not have the promotion of competition among its statutory objectives (though it must have regard to its impact on competition). Competition is good for customers as it fosters innovation, offers choice and widens access. In making its decisions, the FSA should seek to promote competition and avoid the imposition of regulatory barriers to competition. There is a strong case for the Government to introduce a new objective for the FSA to promote competition'.[10]

Nothing prevents a change in approach to consumer protection taking effect now. The powers available to the FSA could address a number of the concerns set out above, although direct competition enforcement powers would remain beyond its remit until legislative reform. Much progress could also be made to change the supervisory approach, the emphasis of which is to keep institutions alive, to one of facilitating orderly failure.

However, to enact the changes we propose, it will be necessary to introduce legislation to alter the regulator's statutory objectives in order to include the requirement to promote competition where possible.

Prudential regulation

As discussed in previous chapters, the banks benefit from an implicit government guarantee.

The Commission has heard evidence that the banking industry enjoys a significant public subsidy, in the form of taxpayers' funds used to protect failing banks from insolvency. Lord Myners noted that:

'The banking industry, because it's been underwritten implicitly against failure, without paying a premium, has enjoyed a huge subsidy'.

This subsidy distorts decisions by banks, fostering riskier behaviour than would otherwise be acceptable, while enabling those banks to raise funds more cheaply. As Mervyn King told us:

Financial Services Consumer Panel

'It is extremely difficult for anyone to manage day-to-day income and outgoings without a bank account and if that facility is lost, even temporarily, consumers may well find themselves forced to use expensive methods of paying bills and even borrowing money to meet their day-to-day commitments…[If a bank did fail] we believe a seamless transfer of banking facilities is required'

BOX 12: REGULATORY TRANSPARENCY

Where a firm treats customers unfairly, or is investigated by a regulator, then disclosure of this information or 'regulatory transparency', can be a powerful tool. It informs consumers of potential problems or concerns with existing products or firms. It ends poor practice. It promotes best practice. It helps firms compete, distinguishing themselves on the basis of customer care or quality of their products.

The disclosure of information is of key importance for financial services. Financial services are vital to meeting peoples' needs, such as buying a home or ensuring financial security. Consumers rely on advice. Many financial products can be complex and difficult to compare in terms of quality. Consumers may want help to understand their needs and to make the right choice. The consequences of making the wrong choice, over a pension or life cover, can be serious. Consumers must be able to trust the source of advice or products. It is because of these concerns that many financial services are 'prohibited' activities: they may only be undertaken by regulated firms.

Financial services have a history of widespread mis-selling. The use of regulatory transparency by the FSA could therefore be an important tool to drive up standards. To date, disclosure by the FSA has been limited. Only in those cases where enforcement has been followed through with a fine or other sanction has a firm or individual been named.

Any disclosure of information by the FSA is subject to section 348 and 349 of FSMA 2000. Section 348 prohibits disclosure of 'confidential information'. The definition of confidential information is very broad. It is any information that 'relates to the business or other affairs of a person' and was received by the FSA 'for the purpose of any functions of the Authority'.

But there are grounds to disclose information (section 349) relating to the facilitation of the regulator's public function, such as providing information or advice to consumers (section 157 FSMA 2000) or information relating to how the regulator intends to meet its wider regulatory objectives.

The FSA has discretion over how it meets these requirements. It has been cautious, disclosing information only where it will 'make a material contribution to the discharge of [a] function'. [11] This has meant that firms under investigation will not be named unless enforcement action is concluded. It has not named the firms it is investigating for failing to treat customers in mortgage arrears fairly. It has not named firms that have been found to fall below required standards when reviewing practices in a specific part of the industry (so called 'thematic' work), such as when reviewing the handling of complaints. Of more concern are those cases where the FSA has found misleading financial advertising but has not named firms that have been required to withdraw or change their adverts.

Some progress has been made. The FSA is disclosing more information about complaints. It could go much further. The Commission believes that the regulator's policy should be a presumption of disclosure of information, especially where disclosure would serve the interests of consumers. The government should test whether the current broad definition of confidential information is a significant barrier to this, and amend the Financial Services and Markets Act if necessary.

- 'Ultimately the heart of the problem does come down, in my view, to the inherent riskiness of the structure of banking that we've got, and the difficulty of making credible the threat not to bail out the system, which is what is underpinning the implicit subsidy and creating cheap funding for large banks taking risky decisions.'

It has been argued that the value of this subsidy is greater for larger than smaller banks.[12] This distorts competition between existing banks and deters potential entrants.

Support has been necessary because no other mechanism existed which would both protect depositors, and allow the continuation of the essential services that the banks provide once an institution had failed. Without these arrangements it has been necessary to support the whole bank, not just the assets and liabilities linked to essential or socially useful banking activities, such as payment transmission or customers' deposits.

In Chapter 2, we addressed how a change to the structure of banking can both protect consumers and ensure the orderly restructuring of any bank that fails. In the following section, we discuss the implications of this for the regulatory structure; what roles it now plays, and, perhaps more importantly, what duties and responsibilities the banks and their boards will need to shoulder.

The shortcomings of the current supervisory approach to prudential regulation

The Commission has heard evidence that, under FSMA, the FSA's regulatory approach to setting, monitoring and enforcing standards of conduct has become too 'supervisory'. The behaviour of the banks before the financial crisis suggests their management believed it was the regulator who was responsible for micro-prudential regulation, not the bank itself.

The Commission believes that greater and more intense supervision is the wrong approach. The regulator will be a backstop to ensure continuity of service. But it is the bank itself which must be responsible for its own solvency, just as in any other industry. When a bank fails, it must not (a) threaten key banking services such as deposit or payment systems, (b) endanger the financial sector as a whole, or (c) imperil the public purse.

The prudential regulator would take pre-emptive steps to:

1 Protect ordinary depositors, including by putting basic deposits above all other creditors in the liquidation preference, as discussed in Chapter 2;

2 Ensure the continuity of all essential services provided by an institution; and

3 In the case of any institution that is too big, or otherwise too significant to fail, intervene to restructure that institution such that its failure would no longer present a systemic risk.

These proposals have two important implications. First, the prudential regulator will be the guardian of living wills. It will supervise the introduction of, and monitor, living wills with the powers required to ensure that essential services continue to be provided even after a bank has failed.

Second, the prudential regulator will have specific powers to restructure banks where it is not possible to construct a credible living will.

It is imperative that no institution remain 'too big to fail' because, with an implicit government guarantee still in place, that institution will continue to have an incentive to take excessive risk at taxpayers' expense. The only way to exit from that guarantee will be to restructure the institution so that it can fail without causing systemic risk.

In effect, there will be two ways to force banks to restructure. First, competition concerns, such as concentration in the industry, will be addressed, as they are today, by the OFT making a reference to the Competition Commission. If the Competition Commission agrees with the referral, it can order that the institution be restructured. Secondly, the prudential regulator would be able to intervene to break up an institution if it deemed that it was 'too big to fail', and as a result was posing a contagion risk to the highly interconnected financial sector.

The risk to consumers, and to the financial system as a whole, of a bank becoming 'too big to fail' is significant, and requires robust action in those circumstances where conditions cannot be put in place to allow orderly failure.


DAVID DAVIS


LORD MYNERS

The lessons of other regulated industries have not been applied to financial services. In other industries, regulators strive to establish the pre-conditions for effective competition. It has always been recognised that for effective competition to be possible, the regulator has to ensure there are specific arrangements which allow firms to fail while ensuring the continuity of essential services. For this reason, arrangements are put in place, such as special administration or supplier of last resort regimes.

Mervyn King highlighted this view in his evidence before the Commission:

> 'The lessons from regulation of other industries I think are… don't try to pretend that regulators can ever be so clever as to stop banks from taking risks that will one day be serious, but try to make sure that if those risks do occur, that the system has firebreaks and firewalls within it so that the parts of the system that you really, really care about and cannot afford to go under – the payment system [and] retail deposits – are completely separated from the things that could go wrong'.'

A financial services regulator with powers to ensure the orderly failure of financial institutions is not without precedent: in the United States, the Federal Deposit Insurance Corporation (FDIC) has, within its wider mandate, the power to monitor troubled institutions and, if necessary, (a) change the management of undercapitalised banks or (b) declare critically undercapitalised banks insolvent and take them over in order to either restructure or manage the receivership of such institutions.

In 2009, 140 banks were taken over, and it is thought that the number of failures in 2010 may surpass this. Critically, the FDIC ensures the continuity of the banking services provided by failed institutions. In this role, and in its role as insurer of bank deposit accounts, the FDIC is funded by premiums from qualifying financial institutions for deposit insurance coverage, and income derived from investment of these premiums in government bonds.

The Commission proposes that the prudential regulator's powers extend beyond basic banks to all financial institutions. The Commission notes that it is the intention of the US Congress to extend the powers of the FDIC to achieve a similar goal.

BOX 13: CURRENT MEASURES TO ADDRESS BANK SOLVENCY

Higher capital requirements

Pre-crisis some banks operated with core capital as low as 2%. In the future, this is likely to rise significantly, perhaps even as high as 10%.

Risk weighted assets (RWA)

The more risky an asset, the higher its RWA and in turn, the more capital required. The relevant risk assessments are being recalibrated.

Dynamic provisioning

It has been suggested banks should be forced to 'lean against the wind'. This means keeping back capital in the good times which can be drawn on in lower parts of the cycle.

Increased liquidity

The FSA has already increased the requirements on banks to hold more government bonds. However, this is likely to become even stricter.

Lower overall leverage

Pre-crisis, leverage was, in some cases, of the magnitude of 50 times equity. This is likely to be lowered dramatically.

MERVYN KING

Jon Danielsson, London School of Economics

‘The problem with banking is [it is] so complicated that any financial institution can make any number look any way it wants, meaning that if the government starts to target anything, the banks find a way to bypass the target’

▸ As discussed above, the Commission believes the absence of genuinely effective markets, which allow poorly performing market participants to fail, has distorted competition by giving undue advantage to incumbent banks. The efforts to secure financial stability have seen regulators keep an existing bank operating when, in normal conditions, it would have failed.

Despite the FSA’s intentions not to operate a ‘zero-failure’ regime, we have seen throughout the recent crisis that few banks were allowed to fail. This was the almost inevitable corollary of neglecting to make appropriate arrangements to manage bank failures in an orderly manner. The current regulatory regime has been unable or unwilling to contemplate structural reform of banks too large or complex to be allowed to fail, as recently noted in the Financial Times:[13]

> ‘The point about a resolution regime is that the balance sheet of a failed bank is distributed among the solvent survivors. Thus, the natural process of concentration is given an extra push at the extreme; this could leave us with a handful of banks so big that in a systemic crisis, they could no longer swallow each other.
>
> ‘The regulator’s answer to all this is that breaking up an industry is a matter for the competition authorities. But their job is to protect the consumer, which is quite a different thing. They are not competent to judge whether the system has reached a point where resolution is no longer feasible.’

Making the banks responsible for the risk of failure

We would note the important outcome to this regulatory approach - responsibility for prudence - must lie with the banking institution and its management, and not in effect be delegated to the regulator.

The Commission is of the view that the current supervisory approach to prudential bank regulation has two particular problems.

First, the increasing trend to put reliance on the regulator’s supervision of compliance with international capital adequacy and accounting standards, such as Basel II, has created perverse incentives for banks to ‘game’ the rules and increase their leverage to the maximum permitted levels. Northern Rock famously proposed a return of capital to its shareholders because of a change in these rules.

We must avoid the situation where supervisory prudential regulation can all too easily turn into ‘shadow management’. Responsibility for the appropriate capital adequacy and risk management must be put back where it belongs: with the boards and executives of banks and other financial institutions.

Second, there is a limit to how effective the supervisory, or ‘shadow management’, approach can be to regulating individual firms.

In evidence to the Commission, Mervyn King cited the example of Citibank, which still faced near collapse during the crises, despite high calibre management and very close supervision by ‘dozens’ of regulators embedded within the firm. Mervyn King noted to the Commission:

'I cannot believe that any regulator around the world could honestly pretend that they would do better than what happened [at Citibank], and I think we have to recognise that sometimes things happen which are almost impossible to anticipate, hard to calibrate in advance in terms of how much capital you need to put aside, or how much cash you need to bank, in order to be sure that you won't get into trouble… Having a system that's robust with respect to that seems to me of fundamental importance, and as I understand it, that is exactly what regulators in other industries supplying utility services would encourage us to do so.'

In addition, and by definition, supervisory regulators will always be outnumbered by market participants who retain an informational advantage. Given the tendency we have seen on the part of financial institutions to operate up to the very fringes of what the rules permit in an effort to boost returns, this means there will always be a limit to what micro-level supervision can accomplish.

Andrew Haldane supported this assertion, noting that there are incentives in banking to create risk: 'There are natural incentives within the financial system to generate tail risk and to avoid regulatory control'.[14] He went on to note that the ability of a supervisor to control this risk may be impossible:

'Putting uncertainties to one side, assume the policymaker could calibrate perfectly tail risk in the system today, and the capital necessary to insure against it. Banks would then have incentives to position themselves one step beyond the regulatory buffer, to harvest the higher returns that come from assuming tail risk. They do so safe in the knowledge that the state will assume some of this risk if it materialises'.[15]

Martin Taylor, the former chief executive of Barclays, put this view pithily in his evidence before the Commission:

'I don't believe that regulators can outwit necessarily determined traders. The traffic wardens don't break up the drug cartels.'

This issue is exacerbated by the real risk that supervisory regulators, frequently ex-market participants themselves, might see issues through the eyes of the industry. Professor John Kay eloquently expressed this view, writing:[16]

'Supervision is subject to regulatory capture, an inclination to see the operation of the industry through the eyes of the industry and especially through the eyes of established firms in the industry. Because the supervisor's conception of best practice is necessarily drawn from current practice, supervision is supportive of existing business models and resistant to new entry.'

The Commission is therefore convinced that an increased supervisory approach, as has been advocated by certain commentators, is not the solution to identifying and preventing future financial crises or making market discipline work. Indeed, the Commission believes such an approach will inevitably fail. What is required instead is a fundamental change: banks must take responsibility for their own prudential management. Regulators will only be there to set limits. And critically, their role will not be to guarantee the status quo, but to allow for orderly failure.

The Commission views this shift of clear and unambiguous responsibility from regulator to management to be of fundamental importance in securing a change of culture in the financial sector. A board will no longer be able to rely on the regulator to provide the assurance that the company's safety standards are adequate. The board will have no choice but to take prudential responsibility as a critical duty, with serious implications for individual directors if they do not.

Equally, the Commission also believes the selection of directors and senior management is the responsibility of the institution. There is the danger that if the FSA is seen to be too closely involved in vetting recruits for the boards of financial institutions, it will end up assuming responsibility for their appointment. While the FSA would continue to certify those working in the financial sector for basic competence, through its testing procedures, the decisions for senior executive selection should be the responsibility of the company and its shareholders.

The proposed changes to prudential regulation are fundamental and will take some time to implement effectively. Individual scrutiny of banks' structure and balance sheets, negotiation to meet the requirements of living wills, and legislative change to make clear the responsibilities and powers for prudential regulation, may be necessary. For this reason, the Commission envisages it will take time to make the changes proposed in the supervision of banks.

Some steps can be taken immediately, but the main changes would probably have to await legislation to enable the regulator to restructure those banks that pose a systemic risk, in order to allow the safe and orderly failure of banks that become insolvent.

Systemic risk regulation

The Commission's primary recommendations relate to the new and redefined roles of consumer protection and prudential regulation. There is a third essential regulatory function in the financial sector - macro prudential regulation - which needs to oversee systemic risk.

The purpose of systemic risk regulation is to oversee liquidity and capital standards at a macro level, and to translate the macro standards down to individual firms. It is concerned with the inter-dependence of banks and their exposure to common economy-wide shocks that may affect key sectors, such as commercial and domestic property. Its role is to act counter cyclically, to 'take the punch bowl away' when asset price bubbles grow unsustainably. This is not an easy task, and the organisation has to have the credibility and the backbone to run against the market.

A key feature of the last crisis was that many banks had many similar and common exposures to the same types of assets. A systemic risk regulator would be concerned with this, and take steps to mitigate these risks. As a result, we will always require systemic risk regulation.

However, as set out in Chapter 1, this alone cannot prevent a financial crisis, not least because of the risks of regulators becoming victims of 'flawed intellectual models', and the incentive that this creates for banks to find their way around targets or rules, to maximise 'tail-risk'.

There are considerable ongoing efforts around the world to increase the overall stability of the financial system. These are briefly summarised in Box 13, p49, and should improve the safety of the financial system in the short term.

There will be an ongoing role for macro-prudential regulation to address systemic risk within the approach outlined in this report. However, as noted throughout this report, regulation cannot replace the competence of a bank's own management to ensure the safety of an institution, and this is where, ultimately, responsibility lies. We should not rely on the measures in Box 13 as being sufficient.

Conflict in regulatory objectives

The Commission is concerned that certain factors, which the FSA is obligated to consider within its general remit to maintain market confidence and protect consumers, may potentially come into conflict with each other, with potentially anti-competitive effects which favour established market participants.

The factors to which the FSA must have regard include:

- The desirability of facilitating innovation in connection with regulated activities;

- The international character of financial services and markets, and the desirability of maintaining the competitive position of the UK; and

- The desirability of facilitating competition between those who are subject to any form of regulation by the FSA.[17]

The duty to have regard to 'the international character of financial services and markets, and the desirability of maintaining the competitive position of the United Kingdom' should be abolished as a specific objective when regulating banks. This objective creates a conflict of duty and tends to support the status quo and discourage new entrants. International competitiveness is best served by ensuring that domestic banks are able to compete effectively, without subsidy or special treatment. Promoting the success of British industry is a job for the government and the industry trade bodies, not for the regulator.

The Commission further questions whether facilitating innovation should be specifically included in the list of principles which the regulator must consider, as this presupposes that innovation in financial services is always beneficial.

JEFF PRESTRIDGE

LORD TURNER

Consumer on www.bnbb.org

'Everything is now so complicated that many are now looking to get companies that do simpler deals. Of course, this is what it is all about, confuse us so much we give up trying to compare like for like and end up taking a deal and hoping we done right!'

In evidence before the Commission, Lord Turner questioned the validity of these duties, stating 'there's a case that they should be looked at again'. He went on to say:

> 'I've always believed that there is a doubt as to whether they should be there. I'm not sure at all that a regulator should have regard to the competitiveness. Now let's be clear, that is something different from the quality of competition... I think that it can be a legitimate aim of a regulator because competitive intensity is a reasonable tool, but I think when you start saying that the role of a regulator is to help, as it were, the competitiveness of a location or of the nationally registered firms, I think that can in a subtle way create a conflict of interest'.

Independence of the management boards of the regulators

Throughout its existence, the FSA has been dominated by people from the companies which it regulates, some of whom are still serving.

The danger of the poacher turned gamekeeper is twofold. First, there is a tendency to codify industry practice and to police abuses within the existing framework, rather than assess whether the relevant market operates efficiently. In an investigation into the appropriateness of certain remuneration structures, for example, current or past beneficiaries of those structures cannot ever be truly objective. Turkeys do not, after all, vote for Christmas.

Second, there is an inherent bias in favour of industry participants over their customers.

In future, the board of any financial services sector regulator should be balanced to comprise members who are independent of the industry, while also having members with the background and skills necessary to understand the workings of the financial services sector.

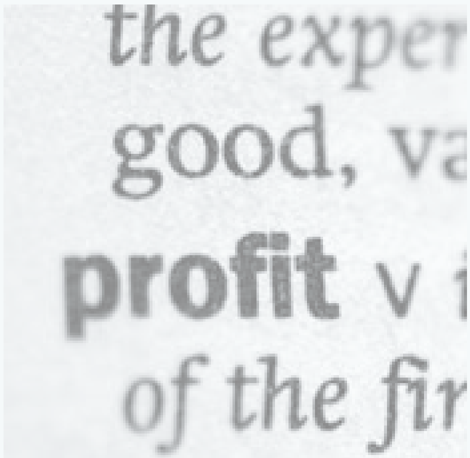
Financial inclusion

The Commission believes access to basic banking services to be a basic right, in the same way that access to services provided by other utility providers, such as gas and electricity, is a right for every member of society.

In evidence to the Commission, Adam Phillips told us that it is impossible to 'function in a modern society without access to ways of transferring money to other people', since consumers need access to bank accounts to receive their salary, pay bills, buy insurance and keep their savings secure. Sian McLean from Toynbee Hall told us that basic banking services supported 'access to employment, access to housing, access to your rent, your social service benefit. It's also access to cheaper products'.

While there has been significant progress in reducing the number of adults without access to a bank account – down from 2 million in 2002/03 to 890,000 today–there continue to be problems for certain groups in gaining access to basic banking services. It is disappointing, for example, that only two of the basic bank accounts on offer are available to undischarged bankrupts, as noted by the FSA consumer panel.

The Commission recognises the progress made by the banks, third sector organisations and the government in reducing the number of adults without access to basic bank accounts. This progress must continue, and greater attention should be focused on ensuring that the characteristics of basic bank accounts are such that access to banking delivers clear benefits to previously excluded consumers.[18] ■



Chapter four

Culture and corporate governance

Neville Richardson, chief executive, Co-operative Financial Services

'It shouldn't be about treating customers fairly because the FSA says so, it should be in the DNA of your business'

Changing the culture of banking

The recommendations outlined in the previous chapters of this report are motivated by the need to align the structure and regulation of the banking industry with the interests of civil society. These changes are necessary but are not sufficient, in isolation, to create a banking industry that serves the needs of society as a whole. Such a change of priority will require not only structural and regulatory change, but also cultural change.

The Commission believes it is the ethics and culture of the industry, which determine the instincts of participants in deciding how to resolve conflicts of interest. The structure of the system can provide the right environment, and can prevent some of the perverse incentives for harmful actions that were a feature of the recent and ongoing crisis. Structure cannot, however, ensure that individuals behave as their customers, and society as a whole would wish.

Similarly, while the regulatory regime can prevent the worst excesses, it can do little to prevent the damaging actions that have not yet been thought of. We have seen the inadequacy of laissez-faire systems of regulation, and we have seen the inadequacy of detailed prescriptive rules. More recently, we have seen the FSA acknowledging the limitations of principles-based regulation as a way to prevent poor behaviour.

The banking industry is in a dilemma when it comes to culture and values. It knows how it should behave but it also knows that in its complex, competitive and conflicted modern environment it cannot live up to the ideal. This can be illustrated by the investment bank Goldman Sachs, which is unusual in publishing its ethics code.[1] This states:

> 'Integrity and honesty are at the heart of our business. We expect our people to maintain high ethical standards in everything they do, both in their work for the firm and in their personal lives.'

But Goldman Sachs, rather ominously, adds a rider:

> 'From time to time, the firm may waive certain provisions of this Code.'

We accept that bankers face so many competing demands that it can be hard for them to know which way to turn, as evidenced by Lord Myners when describing the pressures facing Chuck Prince, former chief executive of Citigroup.

Lord Myners noted that even if Mr Prince believed risk was being fundamentally mis-priced, and that competitors were pursuing risky strategies that would ultimately end in disaster, market pressures meant that Citigroup could not step away from those activities and had to keep 'dancing'. Where an activity is profitable, legal and common practice amongst other banks, shareholders and boards expect executives to keep up with the pack, and this is precisely why the industry needs reform.

We were frankly astonished that a spokesperson for the British Bankers Association recently said:

> 'It's not ethics that were the cause of the credit crunch – international standards on capital and setting risk were wrong. Ethics and remuneration played only a small part.'[2]

This is not the view of the Commission and neither was it the view of most of the witnesses who gave evidence. Many acknowledged the importance of culture and ethics in banking, and also the need for reform. Stephen Green, chairman of HSBC has said:

> 'It is as if, too often, people had given up asking whether something was the right thing to do, and focused only [on] whether it was legal and complied with the rules'.

He told us that:

> 'No banking business can afford to do without a board-led, senior management-supported, ethical approach to behaviour– to understand that there is a purpose to the business that you do, which is not simply measured by short-term profitability,... is profoundly important. Unless that culture is there in an organisation, no amount of rule setting and no amount of careful compliance is going to be an adequate substitute.'

HECTOR SANTS AND LORD TURNER

▶ Lord Turner and Hector Sants, the chairman and chief executive of the FSA respectively, also noted that an appropriate culture was essential for a successful banking system. Lord Turner went so far as to question whether it was right for banks to create products which help their clients avoid tax or regulatory requirements to hold capital:

> 'I think that is quite a major ethical issue which I think the banking industry, and that's primarily [the] wholesale end rather than the retail end, has not faced in the past'.

We need to focus on getting banks to behave better, not in response to a detailed rulebook, but because it is part of their culture. While we want to see a see a new emphasis on appropriate standards, we also recognise that the change of culture will need to be reinforced by ensuring that bank staff are incentivised to work in their customers' interests. We must also ensure there is a proper system of checks and balances in place.

The Commission recognises cultural change is difficult to bring about, and cannot by its nature be accurately prescribed. That does not mean it is impossible to effect. In part, the recommendations on bank structure and competition, made in Chapters 2 and 3, will affect culture. However, there are two other areas where change is needed.

The first concerns overall governance of our banks. As discussed in Chapter 1, there has been a dangerous assumption that there are only two players in determining what activities banks undertake - the banks themselves and their regulators. Such a model is always in grave danger of capture by a 'flawed intellectual model'. There were other checks and balances in the system which failed to work, the dogs that did not bark. These include non-executive directors, the auditors and credit ratings agencies.

The Comission believes the governance of banking activity requires a 'balance of powers' encompassing independent directors on boards, shareholders who give and exercise oversight in approving directors; remuneration structures which reward long-term performance rather than short-term risk taking; and auditors who will report on a bank's activities with professionalism and independence. In the first part of this chapter, we review how we might strengthen and improve the role of some of these agents. In doing so, we believe it will be possible to change culture and therefore behaviour, both immediately and over time. It is these checks and balances which are our best defence against being captured once again by a 'flawed intellectual model'.

Second, the Commission believes that if the banking sector is to win public confidence it needs to change from being seen as a self-interested industry, to something more akin to a profession. The individuals within the industry need to be seen to be motivated not just by their personal financial reward, or that of their firm, but also by a deep-seated belief in the principles by which their industry operates. This will require a new approach to defining the culture within financial organisations and to ensuring that all levels of the organisation adhere to it.

Corporate governance

The Commission has sympathy with the very forceful sentiments expressed by Sir Christopher Hogg, chairman of the Financial Reporting Council, the body responsible for oversight of corporate governance in the UK, when he said that 'The financial crisis is the result of a massive failure of governance at every level'.[3] The systems of governance which should have kept the long-term interests of the banks, their boards and their shareholders aligned clearly failed.

Proposals for reform in banking governance have been led by Sir David Walker's government-sponsored review of corporate governance in financial institutions. His key recommendations are outlined in Box 14. The Commission believes the Walker Review is a step in the right direction, but that it needs to be reinforced. In particular, a reliance on a 'comply or explain' approach will continue to represent a weakness in the overall drive for improvement.

BOX 14: THE WALKER REVIEW

The key vehicle for reform to date has been the Walker Review of corporate governance. Reforms include the following:

- Extending the role of the remuneration committee to cover firm-wide remuneration policy.
- At least half of variable pay or bonuses should be paid in the form of a long-term incentive scheme with half vesting after three years and the rest after five years. Two-thirds of cash bonuses should also be deferred.
- Greater pay transparency in the big banks by requiring public disclosure of the number of employees earning more than £1m.
- Chairman of the board to face annual re-election.
- Chairman of the remuneration committee to face re-election if report gets less than 75% approval.
- Most non-executives to spend substantially more time on the job.
- Induction process for all non-executives and regular training.
- Banks should have board-level risk committees chaired by non-executives.
- Risk committees to scrutinise and, if necessary, block big transactions.
- Chief risk officer to have reporting line to risk committee.
- Chief risk officer can only be sacked with agreement of board.

Antony Jenkins, chief executive of global retail banking, Barclays

'It is not the size or even the complexity of the organisation which causes the degree of risk, it is the way in which it is operated… the banks that have failed have been characterised by failure to appropriately assess risk and manage it, failure to manage liquidity and failure to manage leverage'

Participant, Which? Big Banking Debate

'If a company makes a product which causes physical harm to its users, the company directors can be prosecuted and fined (even imprisoned) if they are shown to have acted irresponsibly. This principle and the law should be extended to include bankers whose irresponsible or reckless conduct causes real emotional or financial harm to customers'

Bank directors and boards: right people, right duties, right resources

Under current provisions of company legislation in the UK, directors must act in a way that they consider would be most likely to promote the success of the company for the benefit of its [shareholders] as a whole and, in doing so, they must have regard, amongst other matters, to the following six factors:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly between members of the company.

HELEN WEIR

Lord Myners, former Financial Services Secretary

'This is an industry which to some extent, over probably the last two decades, has gouged its clients. It's reported unsustainably high returns on equity…a very competitive industry should not be able to sustain returns on equity of over 20%'

▶ It was clear that some banking executives did consider a wider definition of their duties. Sir Brian Pitman, a former chief executive and chairman of Lloyds, described running a 'safe and sound bank' as a 'public duty'. Other witnesses agreed that there needed to be a broad interpretation of shareholder value.[4] They noted that while the taxpayer remained exposed to failure in the banking sector, an exclusive focus by directors on the narrow definition of short-term shareholder value did not take account of the wider public interests which were affected by the management of individual financial institutions. However, the Commission notes that our financial system can often encourage short-term behaviour in companies, which is often against the long-term shareholder interest.

The Commission recommends that the Companies Act be clarified and if necessary, reinforced by a change that requires directors to give consideration to the effect of a company's activities on the stability of the financial system as a whole, even where this conflicts with a narrow definition of shareholders' interests. There should be a statement in the accounts to the effect that directors believe they have fulfilled this duty.

The composition of boards should support the objective of holding the executive to account. Ideally, boards should have three qualities: the ability to lead the business, the expertise to take good decisions, and the independence to challenge and change course. These qualities are necessarily in tension. Independent people who may have experience outside banking may not have the expertise to challenge the management. However, appointing only experts would make the bank subject to 'group think'. Banks need to get the balance right. For this reason we would suggest that all banks should review their composition to ensure not only that they have an appropriate balance of technical financial skills, but also the independence to ask the searching questions to ensure the bank is serving customers well.

The Commission recommends that non-executive directors should make greater use of their powers to appoint independent advisers to assess risk and to measure customer experience through commissioning their own research. These reports should be disclosed to shareholders.

The Commission is also in favour of devices to assist in creating the sort of challenging debate which the Walker report favours, particularly from those who have a broad perspective on a bank's activities. We would suggest, for example, that:

Non-executives should be charged with particular tasks and particular areas where their 'challenge' is expected. This would help focus the minds of both non-execs, and the rest of the board, on creating a comprehensive skill set. As a first step, stakeholders could compile a list of people who would be well qualified as ▶

BOX 15: BANK PERFORMANCE, RISK AND SHORT-TERM PROFIT

One of the most common metrics used to measure the performance of the banks in the run-up to the crisis was 'Return on Equity' (ROE). Essentially, this is their yearly profit as a percentage of the shareholders' equity capital. Banks could improve their performance on this measure by either running their business more efficiently or by increasing the amount of risk they are taking and holding less capital. The return on equity can be calculated as the return on assets multiplied by a bank's leverage.

Andrew Haldane from the Bank of England noted that: 'Banks unable to deliver sufficiently high returns on assets to meet their ROE targets resorted instead to leveraging up their balance sheet. Higher leverage became banks' only means of keeping up with the Joneses. Management resorted to the roulette wheel'.[5]

Sir Brian Pitman told us that in banking a firm could generate significant short-term profits and remuneration for its employees by taking extra risk. Higher risk and leverage boosts the short-term profits of banks, but makes the individual bank and the overall system less stable. This problem is compounded as Jon Danielsson told us because it was 'straightforward for any trader or financial institution to manipulate the risk measurement ... indeed this is one reason why so many banks lost so much money in the crisis. They were measuring risk incorrectly, in no small measure because they were gaming the system to extremes.

The table below shows how the performance of one major UK bank and how its return on assets fell from 0.94% in 2004 to 0.65% in 2007. However, by using increased leverage and taking more risk, the bank was able to keep its ROE constant at between 18% and 19%.

Between 2004 and 2007, its leverage ratio increased from 16.9 to 25.6, meaning that total assets were an average of 25.6 times the amount of equity capital. This made the bank more vulnerable to any losses which might arise. There was a significant increase in leverage in the bank's investment banking operation.

The subsequent difficulties the firm encountered demonstrated the additional risk which came from this additional leverage. However, it is notable that the additional risk did not show up in the regulatory measures of capital. In fact, the Tier 1 capital ratio actually increased over the period from 7% to 7.3%. Indeed, in April 2007, senior management argued that the bank's high ROE was attributable to 'strong profit generation and capital efficiency'. In its 2007 Annual report, published in March 2008, it said that it was 'strongly capitalised'.

The size of short-term annual bonuses for senior executives was 'primarily based on specific...financial performance measures, such as operating profit, earnings per share growth and return on equity'.

The financial performance measures listed could all be accomplished by increasing risk and increasing leverage. For their performance in 2007, executive directors were awarded annual bonuses of between 160% and 220% of their annual salary (individual awards ranged from £1.4m to £2.68m).[6] None of these were subsequently clawed back following the disastrous losses which emerged.

Year	Return on Assets	Return on Equity	Leverage[7]	Tier 1 ratio
2004	0.94%	18.3%	16.9x	7.0%
2005	0.73%	17.5%	22.2x	7.6%
2006	0.74%	18.5%	22.7x	7.5%
2007	0.65%	18.7%	25.6x	7.3%

Consumer, which.co.uk/banking

‘Directors and senior managers must be prepared to return all their earnings which exceed that of the average bank employee for the past five years following any bank failure. This would force them to take a long term view’

bank directors, and encourage the chairmen of the nominations committee to consult this list before making appointments. If bank behaviour does not change, we believe giving stakeholders nomination rights to the board should be considered, similar to the systems in Sweden and Italy where minority shareholders have nomination rights.

Remuneration: right incentives

Executive pay

There was a strong feeling amongst the public who were involved in the Commission’s consultation that bankers are paid too much and that the remuneration practices in financial services were not sufficiently linked to long-term business performance and the treatment of the customer. The scale of government subsidy received by the major banks compounded these concerns.

Arguably, the public expect that in an efficient market for labour, bankers would be paid broadly in accordance with other professions. For this reason, it is imperative that both individually and collectively, the banks are able to justify their remuneration policies.

Inappropriate remuneration policies pose a particular danger in circumstances where short-term profits can be accomplished at the expense of longer-term risk.

Throughout this report, the Commission has noted the potentially dangerous incentives for banks to borrow more, in order to generate higher returns on their equity capital. This has implications for remuneration. Knight Vinke, an institutional asset manager, told the Commission:

> ‘Management bonuses are generally linked to return on equity, [or similar measures such as] earnings per share. These metrics are affected by accounting policies, off-balance sheet arrangements and corporate structures over which management has an unusual amount of discretion. They are also driven by leverage, but the targets that must be achieved are rarely adjusted for the increases in financial risk...’

In one British bank, Knight Vinke presented figures showing the company had borrowed £70 for every £1 of invested equity, and that in their investment banking division, that ratio rose to more than £200 in some individual years. In the investment banking division, around half of the net income was paid out to staff in remuneration – illustrating the short-term benefits to staff of operating high levels of leverage.

It is perhaps worth reflecting on how powerful this incentive could be. Consider a simple example of a bank which can raise equity capital, or it can borrow at 4%. It is able to charge its customers 5% interest on their loans.

BOX 16: THE IMPACT OF HIGH LEVERAGE ON STAFF REMUNERATION IN INVESTMENT BANKING

Year	Return on Assets	Leverage[8]	Return on average economic capital	Net income (£ billion)	Compensation / net income ratio	Total Shareholder Return: 31st December 2004 = 100
2005	1.5%	207x	34%	4.4	51%	109
2006	2.4%	175x	41%	6.2	47%	136
2007	2.3%	161x	33%	6.2	47%	98
2008	1.0%	197x	20%	2.8	82%	33

Source: Knight Vinke, Bank Annual reports

STEPHEN GREEN AND DAVID DAVIS

Imagine the bank does not borrow. In that case it will lend £100 and make a 5% return on equity. But if it borrowed £100, it could make a 1% margin on that borrowing. It will lend £200 and generate a 6% return on equity. If it borrowed £1,000, it would make a 15% return. If it borrowed £5,000, it would make a 55% return on equity. Now, consider a situation where bank executives keep 50% of the return on equity. That gives them a powerful incentive to increase the borrowing of the bank.

The FSA has noted that prior to the financial crisis, many investment banks calculated net revenue and then determined the total size of their employee's bonuses by reference to a compensation ratio (typically between 40% and 50%).[9] As Sir Martin Taylor has noted,

> 'Paying out 50% of revenues to staff had become the rule, even when [because of accounting rules] the 'revenues' did not actually consist of money.'[10]

Relatively minor changes to remuneration levels would have left the banks better prepared to withstand the financial crisis.

The Bank of England has noted that if payouts to staff had been trimmed by just 10% over the period 2000 to 2007, UK banks would have retained an additional £50bn of capital.

Stephen Green, chairman of HSBC, agreed that there had been 'distortions' in the labour market, which had led to bonuses being paid that did not relate to long-term performance, or the amount of risk being taken. He believed the combination of the codes on remuneration introduced by the G20 and the FSA would bring about 'a more rational structure [of] compensation'.

The Commission is far from convinced that remuneration packages of executives are now appropriate. In evidence to the Commission, Sir Brian Pitman said he still saw 'people coming forward with remuneration systems which will pander to the chief executive for high rewards, not for creating shareholder value, but from some other measurement which will be much easier to achieve than long-term shareholder value, and we've got to get people to stop behaving in that way'. Sir Brian added that achieving sustained growth in shareholder value over a 10-year period was the most important measure, and said he believed in much longer terms for payment of remuneration than just three years.

Financial Mail

'Directors of banks need to be held responsible for mis-selling–and should be fined accordingly. Until directors are held personally responsible for the actions their policy decisions trigger, retail banking will remain blighted by the cult of the hard sell'

Participant, Which? Big Banking Debate

'Why does my bank only want to talk to me when it wants to sell something?'

Sir Brian Pitman, former chief executive of Lloyds

'Incentives for sales targets have been a large part of the problem … It's a little short of crazy to incentivise people to maximise the number of loans they're going to grant'


PADDY BARWISE

▶ The Commission endorses the FSA's increased scrutiny in this area in the UK and looks to the G20 Financial Stability Board to lead a global coalition on the principles of bankers' remuneration. However, the Commission is also concerned that existing proposals do not go far enough in eliminating the rewards for taking short-term risks.

The Commission recommends that remuneration structures for senior executives need to be far longer-term in nature, with reward for financial measures aligned to return on assets, and the creation of sustainable long-term absolute shareholder value over a 5 and 10 year period. There should be no reward for increasing return on equity or earnings per share, which can be accomplished by increased leverage and taking extra short-term risk.

Rewards for senior executives in retail banking should be linked to customer measures including overall satisfaction, complaint levels and their fair resolution and regulatory compliance. The details of these measures should be available on the bank's website, for senior executives as well as for directors.

Sales incentives

While much of the focus has been on remuneration structures for senior executives, the Commission also heard a wide variety

Consumer, which.co.uk/banking

'You cannot deal quickly with banks nowadays as their clerks are made to delay what you want while they sell you something'

Neville Richardson, chief executive, Co-operative Financial Services

'I can say hand on heart that with my organisation people were being remunerated across a balanced scorecard, and that meant that across the entire business, success was measured on customer advocacy, employee engagement, process and profitability'

of concerns regarding the sales incentives, targets and bonuses given to frontline customer-facing staff.

These sales-based incentives lead to a conflict of interest between the consumer and the bank. They encourage banks to recommend courses of action which result in the sale of a product, rather than providing advice that is suitable for the customer. The setting of ambitious sales targets, with the consequent threat of dismissal if they are not met, has a similar effect. This behaviour was highlighted as one of the key problems with banks by consumers attending the Big Banking Debate. They expressed frustration that bank staff would invariably try to sell them products when they were making routine enquiries about their accounts.

Commission-based sales incentives also encourage a move to higher-cost products to allow for the payment of commission. As Citizens Advice has noted, 'incentives on staff to sell a certain volume of products ... are always capable of encouraging bad practice and consumer detriment'.[11] The potential for consumer detriment is particularly great in a market such as financial services, where low financial capability and product complexity leave consumers vulnerable. Furthermore, the poor quality and suitability of the product often does not become apparent until many years after it is sold.

The Commission also received evidence from bank staff, both past and present, and their representatives, who expressed dislike for the sales-focused culture. In comments submitted to the Financial Mail, one bank worker said that

> 'The main problem is that sales targets are set on high and filtered down to individual staff, who are well rewarded if they succeed, and threatened with disciplinary action if they underperform and don't achieve targets. No wonder there is so much mis-selling'.

Another bank adviser described the 'intense' pressure to sell combined with 'withdrawal of bonus payments for minor offences and humiliation in front of everyone for not achieving imposed targets'.

Unless the impact of sales incentives is dealt with, it will be difficult to establish a positive culture. There will continue to be mis-selling scandals; banks will continue to design over-complex products. Bonus payments and sales targets will put pressure on frontline staff to sell at all costs. Supervision by regulators will be fighting against these powerful incentives.

This does not imply that salaries for customer-facing staff should be reduced. Any reduction in sales incentives should be

BOX 17: REMUNERATION TARGETS FOR FRONTLINE STAFF: ROOT CAUSE OF MIS-SELLING?

There have been long-held concerns about the impact of remuneration structures in financial services. In its 2003 report, 'Restoring confidence in long-term savings', the Treasury Select Committee concluded that 'Shifting away from the current commission-based sales system, common in much of the industry, is likely to be a key component of any strategy to rebuild consumer confidence in the industry after the long catalogue of mis-selling scandals in recent years'.[12]

From 2013, the FSA will implement a new system of 'adviser charging', which will ban independent financial advisers (IFAs) from receiving commission on sales of investment products. For banks, these rules will apply to 'advised sales'. However, banks will continue to be able to receive commission for selling other types of products, and to offer bonuses to staff based on the volume of sales. They will also be able to set sales targets and put pressure on frontline staff to meet them. Extracts from FSA enforcement notices below suggest that inappropriate remuneration and sales target strategies played a role in a number of recent mis-selling problems such as the payment protection insurance (PPI) and precipice bond scandals:

'HFC advisers and branch managers were eligible for bonuses which were, in part, based on reaching a target of selling PPI with 80% of the loans (calculated by loan value, rather than numerical loan sales). For example, during the early part of the relevant period (up to June 2005) the attainment of the PPI target penetration rate had a potentially significant impact on bonuses (i.e. it could double and potentially quadruple the value of the bonus)'.[13]

'Alliance & Leicester advisers and team managers were eligible for potentially significant bonuses which were based on the number of PPI policies sold, the value of those sales and the amount by which those sales exceeded target rates. Advisers also received a much larger incentive to sell PPI than on the associated loan. For example, in 2007, advisers receiving inbound calls needed to sell six loans without insurance to achieve the same bonus that they would receive from only one sale with full insurance'.[14]

'During May 2000, it was considered that sales of the Extra Income and Growth Plan (EIGP) were a possible way of getting high volumes of business, thus helping distribution channels reach their sales targets….The financial consultants within the Network were under general pressure to perform and to meet sales targets for all products. The numbers of sales made within the Network were regularly monitored. Area Managers within the Network regularly emphasised the importance of selling the EIGP'.[15]

'On average a sales person could expect to earn four times as much from PPI incentives as from loan incentives. The amount a sales person could make from incentives was substantial – up to two-thirds of their base salary. Telephone sales team leaders were also incentivised throughout the relevant period on the basis of the PPI sales of their teams which created a potential conflict of interest with the supervision of their sales staff'.[16]

PETER VICARY-SMITH AND PHILIP AUGAR

balanced by increases in basic salary and rewards for providing good customer service.

The banks told us that their branch based staff were assessed against a 'balanced scorecard' approach, which assessed short-term financial measures and targets. There were varying practices between different banks. HSBC, for example, told us that variable pay only accounts for 9% of branch staff remuneration. HSBC told us that:

> 'In the past, our assessment of staff primarily focused on their financial performance. Today, 40% of our assessment focuses on our staff's customer service performance. This assessment covers mystery shopping, reviews of the quality of advice provided to customers, and customer satisfaction surveys. Other factors include financial performance and process efficiency'.

The Commission recommends that remuneration for frontline and branch staff should not be linked to sales, and should reward customer satisfaction, the fair treatment of customers, and the fair resolution of complaints. There should be no commission or bonuses received for selling products.

In the interim, the FSA should make it clear that institutions which do not adopt this rule will be subject to close scrutiny, and that senior management will be subject to enforcement action for any remuneration structures or sales targets which contribute to mis-selling by putting excessive pressure on frontline staff.

Corporate governance: shareholder oversight and trustee duties

The majority of the shareholders in big British banks are global pension and investment funds, which seek a long-term return both from their equity and bond investments. These investors should have had little interest in the generation of the short-term gains which were engineered via higher leverage and greater risk.

Given that shareholders appoint bank boards, the question then arises as to why these investors allowed behaviour which was not in their own interests. Lord Myners told the Commission the problem was that these corporations were in effect 'ownerless'. He said:

CLARE SPOTTISWOODE AND DAVID PITT-WATSON

▶ 'Major companies are now owned by the people, through the pension funds, insurance funds, and mutual funds, and other things. But goodness me, [the fund managers] have exercised no control. They've just allowed the control of major companies to slip into the hands of a self-appointed managerial elite … I think it's a very, very pressing economic problem'.

This notion of 'ownerless corporations', is in reality an issue for all publicly listed companies whose shares are widely held. However, it is particularly important for banks because, as the recent crisis has shown, the search for short-term profit can end up, in the long-term, generating huge losses. It is therefore odd, in retrospect, that the fund managers who were acting on behalf of long-term shareholders like pension funds, should have been encouraging banks to borrow and lend more, with the aim of maximising short-term return on equity. Yet such was the case.

Stephen Green, the group chairman of HSBC, told the Commission that:

> 'questions would be asked [by fund managers] about why we weren't gearing ourselves up more, why we weren't buying shares back, why we weren't realising certain assets where the book value was substantially below the market value—all of [which was] rather short-termist in its focus'.

He noted that the market also rewarded those that had generated high [returns on equity], relative to the industry, and high growth relative to the industry, even though this was growth was unsustainable.

The Commission believes the problem partly lies in the way management of shareholdings are delegated from the principal (the individual or the pension fund), to agents, such as fund managers, who are often rewarded for short-term performance.

In the past, when pension funds were established, they were organised through trustee boards, whose duties were strictly limited to serving the interests of the beneficiaries of the fund. In some ways, this may have been too restrictive. For example, some have argued that the narrowness of trustee duties means trustees cannot pay attention to issues of long-term performance in the companies they own, if these do not have an immediate impact on their beneficiaries. Where funds are diversified across thousands of investments, this has often meant that trustees have felt able to ignore their role as an owner to individual companies. Such a position makes little sense to the Commission.

The Commission believes trustee bodies holding shares and other securities have responsibilities of ownership, and should not only be allowed, but should indeed be expected, to exercise them. The law could usefully be clarified on this point.

However, an even larger issue has arisen as trustees have delegated the management of the shares they own. The fund managers they employ ought, in theory, to have the same duties as the trustees who have employed them. If they do not, then as discussed in Chapter 1, the savers' interests are likely to be sacrificed.

As a matter of course, contracts between trustees and agents managing shares on their behalf should ideally incorporate the same fiduciary duties which a trustee owes to their beneficiary.

The aim of this recommendation would be to ensure that before taking an action an agent should first ask himself whether they were acting in the best interests of the ultimate beneficiary of the service, not just whether they were obeying the letter of any contract they may have signed. We would encourage the FSA to consider how this can best be implemented and to monitor the behaviour of fund managers to ensure their duties are fully carried out.

As regards the way in which shareholders undertake ownership duties, the Walker report recommended the status of the 'Stewardship code for institutional investors' be strengthened, and that implementation be monitored on a 'comply or explain' basis. The Commission does not believe that this recommendation is strong enough. First, because the Code does not require shareholders to declare what broad objectives they would set for companies, nor to report actual engagement activity undertaken. Second, because the code is implemented on a 'comply or explain' basis; therefore shareholders can simply explain that they did not wish to comply. Finally, because a version of this Code has been in existence for some years, but has never been properly implemented. The cost of that failure has arguably been very high.

The Commission recommends that implementation of the Stewardship Code for Institutional Investors be mandatory for those fund managers which own bank shares. Shareholders should also be able to state that they ask the boards of banks to 'generate value in the long-term, and to avoid undue risk' or, if they have different goals, should be explicit about what those goals are. Fund managers should report by what process they seek to influence banks, and should report actual engagement activity, and its relative success or failure in influencing management practice.

UK Financial Investments (UKFI)

By necessity, the UK government, on behalf of the people, has become the largest shareholder in the UK banking system. Its aim, over time, will to be to dispose of these stakes. However, in the meantime, on behalf of us all, it should behave as an exemplary owner of the banks in which it holds shares. And it should work with other shareholders to ensure the system of banking into which the public shareholding is sold, is one which is sustainable, for long-term shareholders, customers and creditors. This recommendation should not be controversial, since it is precisely such action the government has asked other shareholders to undertake.

Many of the recommendations in this report cannot be achieved by diktat. Indeed, central to the philosophy of the Commission's work is the importance of checks and balances amongst those who influence the behaviour of the banks; from

ESRC Centre for Competition Policy, University of East Anglia

'There is no reason why a government should not use their 'bailout' stakes in banks to restructure them into less contagion-prone (probably smaller) institutions…[Under the European Commission's required restructuring of Lloyds/HBOS and RBS] certain assets will have to be sold, including parts of the branch networks. However, both banks will be left with larger market shares than they had before making the huge strategic mistakes (including foolish mergers) that broke them and so required such massive bailouts'

competition, audit, and particularly from share owners, who have the power to influence remuneration structures, board appointments, as well as the overall structures of banks.

In all these areas, UKFI should be actively involved in promoting best practice as recommended in this report and elsewhere. In keeping with the duties of an accountable owner, it should report back publicly on the actions it is taking.

Some of the recommendations made in this report will require industry agreement, and hence cooperation with other shareholders. As the largest shareholder in the UK banking industry, UKFI should lead this dialogue.

Longer term, UKFI will sell its stake to investors. Before it does so, it should ensure the new owners will behave as 'good owners', and will certainly not behave in a way which creates the motivation for banks to behave irresponsibly. That will require it to be active today in an international dialogue and to ensure any unintended negative consequences of a change in bank ownership are resolved.

The Commission recommends that UKFI works as an active shareholder, not only to encourage the restructuring of the two UK banks of which it is the majority owner, but also to work with other shareholders to ensure that, at the point of disposal, the structure of the UK banking industry is sustainable for the long term. This should be done in coordination with other shareholders, and its aim should be to help ensure the implementation of the recommendations of this report. In particular, UKFI should work to ensure the needs of long-term shareholders, individual customers, households and firms are placed at the heart of a transformed banking system.

Ultimately, the government will need to reduce its involvement in banking services through the sale of its significant stakes in Lloyds Banking Group, RBS and Northern Rock. In doing this, it will need to balance the short-term need to achieve the highest possible price for the taxpayer, with the need to promote a competitive banking sector. This can be achieved through the introduction of an explicit 'public-interest test', applied to the roll-back of state aid. This test serves existing consumers, future consumers and taxpayers by creating more competitive conditions post-government disposal than prevailed before intervention was necessary.

The public-interest test can be delivered through an independent panel comprising suitable expertise that would develop pro-competitive steps to deliver the necessary transformation. The panel could act in co-ordination with the regulatory authorities, especially the Competition Commission.

As noted in Chapter 3, the financial crisis has left customers facing a substantially more concentrated banking sector. The reform of banking interests of the size of Lloyds and RBS and the sale of Northern Rock, could be used to create a more intensive competitive environment in the short term. Such reform will incentivise wider changes, as other firms in the market will need to respond. The public interest test should also be applied to the restructuring plans required by the European Commission to meet the state aid conditions. If the branches and assets are sold to an organisation with a significant existing presence in the UK market then they may not deliver the improvements in competition needed by customers.

The government should be held to account to ensure that UKFI applies a public-interest test to its restructuring and final disposal of public shareholdings or ownership of banks, to ensure architecture of the industry is safe, and that competition is stronger post-divestment.

JOHN MCFALL

SIR MARTIN TAYLOR

Corporate governance: accounting and auditing[17]

Accurate, clear financial reporting and auditing of banks is crucial to the stability and integrity of the financial system. Its significance is far greater than allowing the effective trading of shares and bonds. Accounting standards can also cause firms to adjust their behaviour, depending on how they are being measured. As the American corporate governance expert Nell Minnow has remarked of our commercial institutions, they 'are just like sub-atomic particles, they behave differently when they are observed'.

The most important, independent observers of our banks are the auditors. In the UK, in contrast to the USA, they are responsible to shareholders. Their reports should encourage good behaviour by banks, and inform the owners, so that they, in turn, can carry out their responsibilities.

In today's financial markets, this requires a high degree of judgement and professionalism. However, private evidence to the Commission from the accounting profession asserted that some of the most fundamental principles upon which such judgement should be based are being eroded in favour of a rules-based approach. Perhaps this is the result of an important exercise to harmonise global accounting standards, perhaps as the result of too much emphasis being given to the legal form rather than the substance of transactions. Either way, there is a danger that the expression of the independent judgement of the auditor could be undermined.

The Commission believes it is of the greatest importance that this should not happen. The recent crisis highlights the critical importance of ethical and accurate accounting practices, not only for consumer and investor protection, but for global economic stability. The audit is a foundation stone for the integrity of our capital markets. The Commission can think of no other objective which should override the need for the audit to provide a 'true and fair' view of the affairs of a bank, or where form should be preferred to substance. These principles should be enshrined in law.

Further, the independence of the auditor provides an additional important check in the system. There are four independent agents whom we employ to monitor and control bank behaviour; the independent directors, the auditors, the regulators and the shareholders. In the UK, more resources are devoted to auditing banks than to regulating them, and vastly more resources than fund managers devote to their role as owners. It therefore seems appropriate to the Commission that auditors are asked to provide specific assurance of the banks' position; not only that their report is true and fair, but also that it is comprehensive; not only that it meets the letter of the regulations, but also that it meets their spirit. If markets and regulators are to work effectively, then banks must tell us 'the truth, the whole truth and nothing but the truth'. If any agent can help ensure that they do so, it is the auditor.

We recognise that auditors themselves face financial pressures, and in particular there is a fear that, if the role of the auditor is not tightly drawn, this may leave them open to legal claims. Should this be the case, then appropriate protections should be given. Certainly it would be bizarre if auditors presented inappropriate reports for fear that, if they produced the right ones, they would be sued!

ROGER BOOTLE

Accounting standards also need to be reviewed. We recognise that for good reason, the accounting standard setters have focused on drawing up accounting standards which can be applied globally. While we recognise the value of this exercise, we are concerned that the baby may be thrown out with the bathwater. We note Martin Taylor's observation to the Commission that 'sometimes the accounting bodies argue in a quasi-theological manner between two alternatives which can both be supported intellectually. It might be a good idea if they chose the one with the better social consequences sometimes'.

Mr Taylor added that during his time at Barclays,

> 'The accounting standards require you to recognise [losses] only when they occur, and that means that banks have overstated profitability in the up phase of the cycle, and understated profitability in the down phase of the cycle'.

This has very significant implications. Essentially, accounting standards are proving to be pro-cyclical. Regulators have mentioned to us that their aim is 'to take the punch bowl away before the party gets out of hand'. But their task will be impossible if accounting standards are refilling the bowl.[18]

Lord Turner told us that the auditors at Dunfermline Building Society, which collapsed in March 2009, were saying at the end of 2006 that provisions against bad loans were too high as no one had yet defaulted. Jon Pain, managing director of retail markets at the FSA, told the Treasury Committee with regard to Dunfermline:

> 'The auditors are looking at the balance sheet and the known impairments in terms of the portfolio. They are not forecasting the future potential losses, that is not the purpose of the audited accounts'.[19]

Given the comments made to us by Sir Brian Pitman, and the discussion in Chapter 1, we cannot see how it is possible to draw up the profit and loss of a bank without some reference to its future potential losses.

Such statements come as a surprise to those who had understood that accounting principles demanded objectivity, consistency, disclosure, and most particularly, prudence and conservatism. As accountancy professor Roy Sidebotham wrote in the 1970s:

> 'There seems to be no limit to the optimism of businessmen... which the growing complexity of the market opens up. The first line of defence of investors and creditors is the vigilance of the practicing accountant. [Accountants] are cautious men, and their caution is expressed in the concept of conservatism.'[20]

He goes on to point out that this should mean that profits should not be recognised until realised; that when in doubt, lower values should be given to assets and higher ones to liabilities. By contrast, the International Accounting Standards Board (IASB) has proposed that the references to 'prudence' or 'conservatism' as desirable qualities of financial reporting information be removed, as these were said to be incompatible with the principle of 'neutrality'.

In the Commission's opinion, the absence of these qualities was an important factor in allowing the behaviour that lead to the banking crisis. Accounting rules and standards therefore need to be rewritten, unilaterally if necessary, to reinstate these disciplines.

The Commission's final recommendation in this area addresses how and to whom the auditor should report. At present, in the UK, the auditor is appointed by the company, but reports to the shareholder. However, it is likely to be the regulator who will also need to act in the event that the auditor has any concerns. The Commission therefore recommends there be a reinstatement of the regulator's use of the auditor to investigate concerns. The Commission notes this has been past practice, but was abandoned

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BOX 18: ACCOUNTING STANDARDS

The IFRS framework states that the 'objective of financial statements is to provide information about the financial position, performance, and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions'.

However, the financial crisis has exposed a number of problems with bank accounting policies, which have limited their usefulness and contributed to financial instability. Rather than being a transparent window onto corporate performance, the reporting methods themselves encourage behaviour that amplifies volatility and can conceal leverage and risk. These include:

- Complexity in the financial statements which mean they are not always clear, accurate and useful to end investors or even to the company's board
- Bank accounting policies can be dictated by the bank's 'intentions', which can change opportunistically. It was noted in evidence to the Commission that banks have a choice of five ways of classifying financial assets, which can produce very different outcomes in terms of the effects on the balance sheet and its profit and loss account. It has been reported that some banks have moved one part of a pair of matching assets from the trading book to the banking book. This means that further deterioration in the economy will deliver an immediate profit for the bank, while the matching asset in the banking book is not written down until actual default occurs. Other banks have chosen to sell securities to 'special purpose entities', while simultaneously extending a loan to those same entities. This means they do not have to include any volatility in the value of these assets in their accounts.
- Loans in the banking book are accounted for at their cost, less an allowance for credit losses. Accounting standards require that the allowance for credit losses can only be recognised when there is objective evidence that impairment has occurred. This has a pro-cyclical effect which leads to banks overstating profitability in the up phase of the cycle, and understating profitability in the down phase of the cycle. The growth in riskier lending was therefore accompanied by increased reported profits because the accounts did not include the inherent cost of this extra risk through higher prospective defaults.
- Accounting rules currently allow banks to register a gain on their books when their credit rating is downgraded.
- Gains from use of mark to market accounting register unrealised profits on the trading book. These could subsequently be reversed, but are recognised as revenues (and paid out in bonuses). These gains swelled capital bases and supported increased trading and lending. But as asset prices rose, firms found themselves below their targets for leverage, allowing them to take on more debt and buy more assets. Conversely, when asset prices fall, a firm

needs to deleverage and sell further assets. This can lead to herd behaviour where banks sell assets because they believe other banks may sell similar packages of assets before them.
- Profits can be recognised in a one-off up-front manner from the sale of long-term products and derivative transactions. For example, banks accounted for sales of single premium payment protection insurance (PPI) in a one-off manner,

even though the consumer would repay the money used to purchase the policy over a number of years. This partly explains why banks resisted the development of regular premium products, which were better value and offered more flexibility to the consumer.

- International inconsistency in the rules surrounding off-balance sheet vehicles mean that banks in the UK applying IFRS would have a different presentation in the financial statements to an equivalent transaction undertaken by a US bank applying US GAAP. Similarly, as evidenced by Lehman Brothers, Repo transactions were accounted for differently under US GAAP than IFRS, as under US accounting rules it was possible to conceal leverage from its balance sheet. The accounting standards should not allow assets and liabilities to move off the balance sheet without trace. Such off-balance sheet transactions result in banks carrying more leverage than investors, clients, trading counterparties and central banks realise.
- The difficulty of measuring leverage of complex corporate structures. Historically, the market, guided by management, measured leverage through regulatory measures such as Tier 1 capital. However, this did not give a true measure of the economic risk being run by a bank.

because it was feared the auditor may not remain independent. The Commission believes this has the logic the wrong way round. Unless the auditor can be trusted to be independent, then the integrity of the capital markets will be compromised.

There need to be fundamental questions asked about the purpose of the audit. The Commission is concerned that auditors failed to report on the higher levels of risk and leverage being run by the major banks.

There should be a reinstatement in law of the principle that financial accounts represent a 'true and fair' statement of the position of the company, and that they are presented in a way which places substance over form. In this context, it should not be possible to arbitrage the UK accounting system.

Auditors should be asked to attest that bank accounts represent a 'true, fair and comprehensive statement' of the affairs of the company, and that they are prepared in keeping with the spirit as well as the letter of solvency and other regulatory requirements.

The accounting principle of 'prudence' or 'conservatism' is relevant when determining whether an asset is recoverable, and therefore has its place in determining loan loss provisions. The quest for 'objectivity' also has its place, through mark to market and other devices, where doing so provides meaningful information (either in the balance sheet or in the notes). Having a robust classification criterion for assets and liabilities, so they are classified appropriately, either at cost or at fair value, is critical to ensuring the numbers reported are meaningful and relevant. Regardless of the measurement basis, there is no substitute for the professional judgement of the auditor.

The auditor should be required to report all significant risk factors which come to their attention as part of the audit. The FSA should extend its current trend of encouraging much more dialogue with auditors and the FSA should require further work from the auditor of any areas of a bank's activities where they have concern. It is important that early work is done to nip things in the bud, and auditors are well placed to help in this activity. This does, however, depend on improving the level of dialogue between the auditor and the regulator. In the unlikely event that auditors find that this creates a conflict of interest, their duties should be clarified to deal with this point.[21]

Corporate governance: credit rating agencies

There are three leading credit rating agencies (CRAs) currently operating in the financial system – Moodys, Standard & Poor's (S&P) and Fitch. These private sector agencies wield enormous power as they provide the basis for decisions by companies, investors, regulators and governments about the relative credit risks associated with a wide variety of bonds and other debt instruments.

Before and after the financial crisis, the CRAs have been exposed to criticism based on what has been judged to be a number of serious flaws in their operations. After all, it was they who declared that securities representing sub-prime mortgages were 'investment grade', despite the fact they had privileged access to the internal financial data about the loans from which the securities were composed. Similarly, and despite having privileged information, the rating agencies gave Enron and WorldCom investment grade status.

At the heart of the criticism of the CRAs is their operating model. They are paid by the issuers of debt, not by those who are buying it. In addition, the CRAs sell consulting services to the companies whose debt they rate. Both these features create huge conflicts of interest.

In addition the three CRAs enjoy a privileged position, because they are deemed by the American SEC to be 'Nationally recognised statistical rating organisations' (NRSROs). Only NRSROs can certify bonds as 'investment grade'.

As a result of these criticisms, the CRAs will be subject to increased oversight in the future. The EU has already taken steps due to come into force later this year. These will increase their control with new powers to increase transparency, and aim to reduce conflicts of interest and assess rating methodologies. The current proposals for financial regulatory reform in the USA are also likely to increase the power of the SEC over these institutions. While these reforms are likely to make a difference to the way the agencies operate, there are still outstanding questions about their overall business model, with the competition problem and the potential for conflicts of interest still outstanding.

Chris Rhodes, group product and marketing director, Nationwide Building Society

'I strongly believe you cannot encapsulate everything you need do in rules and regulations. Therefore, a focus on the value sets and the behaviour in organisation is incredibly key'

BOX: 19 CODES OF CONDUCT IN THE MEDICAL PROFESSION

To practice medicine in the UK, all doctors need to be registered with the General Medical Council (GMC). In 2006, the GMC revised the professional standards expected of doctors. These standards are set out in guidance called Good Medical Practice, and describe what is expected when doctors deal with individual patients, with their colleagues, and when doctors update their skills.

The revised guidance now takes into account current expectations about respect for patients and their active involvement in clinical decisions. It sets out the principles and values on which good practice is founded. The code provides this definition of a good doctor:

Good doctors make the care of their patients their first concern: they are competent, keep their knowledge and skills up to date, establish and maintain good relationships with patients and colleagues, are honest and trustworthy, and act with integrity.

Good Medical Practice is seen as, but not called, the 'code of conduct' by which doctors in the UK are expected to practice. It is a formal expression of professionalism. It is not a statutory code, so doctors must use their judgement to apply the principles to the various situations they face. Although the guidance is addressed to doctors, it is also intended to let the public know what it can expect from doctors.

The 'Physicians Charter' developed by the American Board of Internal Medicine, the American College of Physicians Federation and the European Federation of Internal Medicine in 2002, also contains some particularly interesting notions.

The charter calls for doctors to be honest with patients, provide them with choices on managing their health, improve access and quality of care for patients, and avoid inappropriate conduct with patients. It urges doctors to keep up to date with scientific advances and to report deficient physicians. It also contains clauses that reflect the need for the profession to think beyond self-interest to recognise the changing needs of society. It says that physicians should be committed to a 'just distribution of finite resources'. This clause calls on the physician to seek a balance between the individual patient's needs and the interests of society.

Participant, Which? Big Banking Debate

'Bankers should have professional standards like architects and engineers or they should be struck off for malpractice'

▶ The key problem is that rating agencies compete to offer a better service to those who issue bonds, rather than to those who buy them. For practical reasons, it is difficult to receive income from the many thousands of institutions and individuals who may buy a bond. However, it would be possible to remove conflict of interest if, for example, a bond issuer was 'assigned' a rating agency, rather as a judge might be assigned to try a case. Rating agencies which could show they delivered accurate ratings could be assigned more work, to give an incentive for them to improve their performance, and indeed to encourage new entrants to the market. Alternatively, buyers of bonds could be asked to set up a not-for-profit organisation to review the CRAs' ratings. The funding for these proposals could be raised by a levy on bond issuance.[22]

Whatever route is chosen, the reconstruction of the CRAs remains an important outstanding item in restoring integrity to our capital markets.

A code of conduct for the banking industry

We began Chapter 1 of this report by noting the fundamental importance of banking to our economy and our society. We also note that the current crisis has not been caused by bankers being 'bad people'. Jayne Anne Gadhia, the chief executive of Virgin Money, told the Commission that during her time at RBS,

> 'People wanted to do the right thing for customers, and wanted to do the right thing for shareholders...but the reward and structuring was all around driving profitability'.

She noted that, in contrast, the culture she is seeking to create at Virgin is one which will provide benefits to the customer, shareholders, staff and society.

> 'It's really important to be clear on culture, and then drive it and reward those behaviours, otherwise it won't just happen.'

Banks are essential to our prosperity. They need a culture which encourages fairness, prudence and sustainability, serves the needs of their customers, and makes a positive contribution to society. The Commission believes the principles of good banking need to be reflected in codes of conduct and ethics that truly seek to govern behaviour and to restore trust between the bank and the customer.

In the first instance, we would expect the leadership of the banking industry to take steps to promote a new cultural ethos into their institutions. However, experience such as the failure of the FSA's 'Treating Customers Fairly' regime[23] tells us that this will probably not be sufficient. We will need to supplement this with other influences which will promote good behaviour.

The Commission recommends the development of a 'Good Financial Practice Code'. This code should have a similar status amongst the banking profession as similar codes of conduct have in the medical and other professions.

BOX 20: CODES OF CONDUCT IN THE LEGAL PROFESSION

Practising solicitors in the UK are required to adhere to a code of conduct monitored and enforced by the Solicitors Regulatory Authority (SRA). The SRA is the regulatory arm of the Law Society of England and Wales, and was established in 2007 following a review of legal services by Sir David Clementi, which recommended that the representative and regulatory functions of the legal professional bodies be split.

The core duties set out in the code are as follows

Justice and the rule of law
- You must uphold the rule of law and the proper administration of justice.

Integrity
- You must act with integrity.

Independence
- You must not allow your independence to be compromised.

Best interests of clients
- You must act in the best interests of each client.

Standard of service
- You must provide a good standard of service to your clients.

Public confidence
- You must not behave in a way that is likely to diminish the trust the public places in you or the legal profession.

BOX 21: CULTURE CHANGE IN ACTION: DEALING WITH CUSTOMER COMPLAINTS

There was a strong sense amongst participants in the Which? Big Banking Debate that complaints were not dealt with fairly. Consumers were concerned that it was often difficult to register a complaint, which led to a feeling of disempowerment.

The FSA recently assessed the quality of bank's complaint handling. It found 'poor standards' within most of the banks it assessed. Senior management were not sufficiently engaged in ensuring that customers were treated fairly. There was poor-quality complaints handling by frontline staff, and procedures within some banks led to staff issuing multiple, repetitive responses to customers, forcing the customer to restate their complaint a number of times. Banks also failed to learn from previous complaints, and to make changes to prevent similar complaints arising in the future. In two cases, bank staff incentive schemes encouraged poor complaints handling. In some companies, staff could even receive bonus payments for rejecting valid complaints.

A change of culture in this area would start with a clear statement from senior management that complaints should be assessed fairly, and that redress will be paid when appropriate. It would ensure that management information was in place to monitor and review the quality of complaints handling.

Frontline customer-facing staff would receive training in assessing complaints fairly, with a focus on delivering fair and ethical outcomes. Their incentive structures would reward the fair resolution of complaints.

Complaints processes would be clear and prominently advertised, with a clear statement that a customer could refer their case to the Financial Ombudsman Service (FOS) if they were not satisfied. The bank would actively review the position of customers who were in similar circumstances to those who had complained. It would review and change its sales practices and products in response to complaints.

Only the small minority of complaints which were genuinely difficult to resolve would be referred to the FOS. The bank would report data on its complaints handling to shareholders and non-executive directors, who would put pressure on the firm to deal with complaints fairly and ensure the bank's practices were improved to prevent similar complaints arising in the future.

This should lay out the standards by which bankers are expected to operate, the duty of care they owe to their customers, the behaviours and independence of view that are regarded as essential to a well-functioning profession, and the responsibilities they have to draw the attention of their own profession and regulators to behaviour that contravenes these standards. Such a code is essential where critical services are provided, but where those buying the service find it difficult to judge its value and so need to trust that those providing it are acting in good faith.

The FSA already carries out a 'fit and proper' test for approved persons, which makes an assessment of probity and competency. This means that in order to work in a senior position in an FSA-authorised business, it is necessary to meet certain standards. However, the Commission is concerned that this does not go far enough in addressing the cultural problems in this industry. These standards need to be deeper and broader. They should apply to many more employees, and the standards should go beyond probity and competency to incorporate wider cultural dimensions.

To inform our understanding of this wider definition of culture, we have looked at what is done in the legal and medical professions, and some interesting approaches are highlighted in the General Medical Council's (GMC) Good Medical Practice Guidance and the Solicitor's Regulatory Authority's (SRA) Code of Conduct.

There is a fundamental need to balance the requirements of employees, owners and those of wider society. This will necessitate paying attention to how banks manage conflicts of interest. The Commission believes that adopting some of the core principles from the codes and charters which govern the medical and legal professions–honesty, integrity and client interest–would be an important step in achieving cultural change within the banking sector.

In addition to the development of a Good Financial Practice Code, the Commission recommends that bankers receive compulsory formal training before they are able to fully practice in their profession. This should include training in the ethical behaviour expected of the members of their profession, including how to resolve conflicts of interest. An understanding of, and commitment to, the high professional standards in the Good Financial Practice Code should be a compulsory and significant part of such training.

Any code or charter needs to be enforced to have meaning. The Commission recommends that this Code should be devised and enforced by a new professional standards body along the lines of the General Medical Council, or the Legal Services Board. This body should be independent of both government and the industry, and should have a lay majority on its board. A crucial element will be the power that this body should have to discipline members who fail to uphold the code, and in extreme cases remove their ability to practice.

These recommendations constitute a radical reform of not just the way in which bankers operate, but also the way they perceive themselves and their behaviour. We want to see a new emphasis on appropriate standards, which will underpin an industry which is and is seen to be focused on delivering the critical services upon which our prosperity depends. ■

Annex 1

Terms of Reference

The original purpose of the Future of Banking Commission was

'To establish a reformed banking system that serves the needs of ordinary people and the wider interests of society'

We established an independent banking commission with the primary aims of:

- Listening to the public's concerns about banking
- Listening to the perspectives and concerns of industry and other bank stakeholders
- Enabling the restoration of public trust and confidence in the banking system

The questions the Future of Banking Commission sought to answer were as follows:

1 The social function of banking

1a What are the essential and socially useful services which banks provide to people and how can these be protected from instability?

1b What is the impact on the citizen as a banking customer, taxpayer and shareholder (in banks and other quoted companies) of investment banking activities?

1c What can be done by each of the stakeholders in the system to better deliver the social benefits of the banking system?

2 The impact on the public of the financial crisis

2a How have the public been affected by the problems in the banking and financial sectors?

2b What impact has it had on their trust and confidence?

2c Are banks treating customers fairly?

3 The appropriate structure of the banking system

3a What are the strengths of the current model?

3b Do the essential banking services need to be separated or ring-fenced from more speculative activities, and if so, how should this be accomplished?

3c How do we ensure that the state and the public do not offer unlimited insurance against losses, while allowing the gains to be privatised?

4 Sustainability

4a How do we put a system of incentives in place which aligns the interests of customers, banks and investors?

4b How do we ensure that well-managed institutions, which treat their customers fairly, are able to thrive?

4c How can the system return shareholder value while delivering good customer outcomes and systemic stability?

5 Competition

5a How do we ensure that competition, particularly in retail banking, works to deliver benefits for customers?

5b How do we facilitate entry and exit from the industry without damaging customers' interests?

5c How can the government make competition stronger, post withdrawal of State aid, than existed before taxpayers' money was used to bail out the banking system?

6 Corporate governance, remuneration and accountability

6a How do we reform the role of boards and non-executive directors so that they are effective in monitoring and controlling activities which are damaging to customers?

6b How can remuneration be linked to fair treatment and good outcomes for customers and avoid rewards for taking excessive risk?

6c What is the role of institutional investors in ensuring that banks avoid excessive risk and treat customers fairly?

7 Regulation of the banking sector

7a How can macro/micro prudential and conduct of business regulation deliver good outcomes for customers?

7b How does the system of deposit insurance need to be reformed?

7c Are there characteristics of a regulatory system that would provide a global competitive advantage to the financial industry in Britain, and what are said characteristics?

8 Provision of suitable products to consumers

8a How do we ensure that products are transparent, simple and easy to compare and switch between, offer value for money and do not levy excessive charges?

8b What impact would greater regulation of products have on innovation?

9 Impact on customers of reform

How will any proposed reforms impact on customers in both the short and long-term? ■

Annex 2

List of Witnesses and Evidence

Oral Evidence

9 February

DAVID HARKER
Chief Executive, Citizens Advice Bureau
SIAN MACLEAN
Toynbee Hall and Transact
ADAM PHILLIPS
Chairman, Financial Services Consumer Panel
JEFF PRESTRIDGE
Personal Finance Editor, Mail on Sunday and Financial Mail
WILL HUTTON
Executive Vice Chairman, Work Foundation
BRENDAN BARBER
TUC General Secretary
JOHN WRIGHT
National Chairman, Federation of Small Businesses
ADAM MARSHALL
Director of Policy and External Affairs, British Chambers of Commerce

25 February

MERVYN KING
Governor of the Bank of England
PATRICK BARWISE
Chairman, Which? Council and Emeritus Professor of Management and Marketing, London Business School
JANE DAVIS
Small business owner and Nationwide customer
GILL KIRK
Former HSBC employee
CLAUDINE BAXTER
Retired teacher
JAYNE-ANNE GADHIA
Chief Executive Officer, Virgin Money
SIR BRIAN PITMAN
Chairman, Virgin Money
CHRIS RHODES
Group Product and Marketing Director, Nationwide

NEVILLE RICHARDSON
Chief Executive, The Co-operative Financial Services
JOHN KAY
Visiting Professor London School of Economics and Fellow of St John's College, Oxford.
DR JON DANIELSSON
Reader in Finance, London School of Economics
DR JULIAN FRANKS
Professor of Finance, London Business School

15 March

ANTONY JENKINS
Chief Executive Global Retail Banking, Barclays
STEPHEN HESTER
Chief Executive RBS
STEPHEN GREEN
Chairman HSBC
PAUL THURSTON
Chief Executive HSBC plc
SIR MARTIN TAYLOR
Former Chief Executive Barclays
HELEN WEIR
Group Executive Director (retail banking) Lloyds-TSB

18 March

LORD MYNERS of Truro in the County of Cornwall
Financial Services Secretary
LORD TURNER of Ecchinswell in the County of Hampshire
Chairman Financial Services Authority
HECTOR SANTS
Chief Executive Financial Services Authority
PHILIP COLLINS
Chairman, Office of Fair Trading
CLIVE MAXWELL
Senior Director, Services Sector, Office of Fair Trading
ROBERT PESTON
BBC Business Editor

Written Evidence

Bank of England

Barclays Bank

British Bankers Association

Building Societies Association

Cap Gemini

Citizens Advice Bureau

PHILIP COLLINS
Chairman, Office of Fair Trading

PROFESSOR SIR TIM CONGDON
Chief Executive, International Monetary Research

Co-operative Financial Services

Coventry Building Society

DR JON DANIELSSON
Reader in Finance, London School of Economics

SHEILA DOW
Emeritus Professor of Economics, University of Stirling

Financial Mail (Mail on Sunday)

Financial Ombudsman Service

Financial Services Authority

Financial Services Consumer Panel

CHARLES GOODHART
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HM Treasury

JOHN KAY
Visiting Professor London School of Economics and Fellow of St John's College, Oxford.

Knight Vinke

Lloyds TSB

PROFESSOR DAVID MILES
Visiting Professor of Finance, Imperial College London and Managing Director in Economic Research, Morgan Stanley

Morgan Stanley

Dr Pavel Pinkava

Sir Brian Pitman

Post Office

RBS

LORD TURNER of Ecchinswell in the County of Hampshire
Chairman Financial Services Authority

Unite

PROFESSOR BRUCE LYONS, DR LUKE GARROD AND DR MINYAN ZHU
University of East Anglia: Centre for Competition Policy

Virgin Money ■

Annex 3
The Which? Big Banking Debate

The Future of Banking Commission sought to hear the views and stories of as many consumers as possible, to help shape the conclusions of this report. To do this, Which? launched the Big Banking Debate, the culmination of which saw 300 people gather in central London on 4 February to discuss the future of the banking industry. Interviews were also conducted up and down the country, while consumers were encouraged to leave their views on the Commission's website.

Below is a summary of the main themes that emerged from the Debate, all of which the Commission has aimed to address via the recommendations of this report.

Level of service

One of the main concerns to emerge from the Big Banking Debate was the deterioration in levels of service from banks in recent years.

In particular, many consumers felt there to be a distinct lack of personalisation and 'localisation' of services – claiming that banking today is not tailored to one's needs.

One participant summed up the traits they would like to see in people they deal with at their bank – 'helpful, courteous, knowledgeable, skilled.' Many people value the idea of having face-to-face contact with an old-fashioned-style bank manager that you recognise, and who recognises you.

People feel there is a lack of ownership at their bank when it comes to dealing with any issue or complaint. There is a sense that complaints handling and redress are handled inadequately, leading to a sense of disempowerment of consumers to change anything.

Unlike other industries, banks no longer have any great incentives to offer good service, or good quality products. Customers have shown that they are largely unwilling to switch providers even when they are treated poorly, and the complex nature of banking products mean that many consumers are unaware when they are sold an unsuitable product.

To help make switching between bank accounts easier, and to encourage banks to compete on service, the Commission recommends that regulators consider forcing banks to introduce portable account numbers.

Remuneration

Perhaps one of the most emotive and contentious issues that has been highlighted by the crisis is the issue of remuneration. At a consumer level, this manifests itself in a dissatisfaction with commission driven sales. There has been, for many people, a noticeable shift away from a more personalised banking service to one driven by sales targets.

What people appreciate when it comes to financial services but seems to be lacking due to the focus on sales, is a lack of independent advice and more of a personal understanding and knowledge of clients needs. One participant said they felt like part of an anonymous clientele based on a points system. There is a distinct need for impartial advice from knowledgeable, expert help from properly trained staff.

At the other end of the scale, made even more acute by the banking crisis, is the issue of senior bank bonuses. People are very clear that any reward should be based on long-term success, with more encouragement of shareholders to exercise their rights to vote against high pay and bonuses that are perceived to be rewarding failure.

There is a huge sense of inequity amongst those who believe that taxpayers have borne the brunt of the massive bailout of financial institutions while those at the top of the system have continued to receive huge payouts. Indeed, it has been suggested that taxpayers who now have substantial stakes in some of the banking institutions should have a direct say in whether bankers deserve their rewards or not.

The Commission recommends that banks are banned from incentivising their staff to sell certain types of products. Incentives should be based on providing a good service to the customer.

Products

Lack of transparency is a particular issue in financial services, and it is certainly an issue that consumers spontaneously raise frequently when asked about their experiences of financial products. This is with regards to the terms and conditions and small-print associated with products, the perceived unfair charges levied which often take people by surprise, and lack of information on monthly statements about the current interest rate on that particular product.

There is a sense that charges are 'sneaked' into the small-print of products, making it difficult for consumers to get adequate clarity on what they are buying and leaving some feeling as if they are purposely designed to trip you up.

Many felt that charging structures and fees for products, such as overdraft facilities and mortgages, were unfair and inequitable. One issue which is particularly emotive is around unauthorised overdraft charges, and the debate online and in other forums reflects this.

People accept that there are inevitably going to be costs associated with any financial product, but they do not feel they are always a true reflection of the actual costs and disproportionate to what they would expect to pay.

A further issue that was raised relates to irresponsible lending. It is felt that proper assessments of a customers' capacity to repay is needed, as in the past there has been too much pressure placed on people to take loans and credit cards, leading to a culture of 'borrow and spend'. It is felt that vulnerable people in particular are at risk of being sold to irresponsibly. One participant discussed how they are semi-retired on a low income, but was offered a loan of £25,000 which they could clearly not afford to pay back. It is believed that a lack of proper assessments of risk, both on a broader scale of the whole banking system and in terms of an individual's ability to pay, are one of the key features of the crisis

Trust and confidence

One thing is clear – trust and confidence in the banking system has been severely shaken over the last couple of years. There is a strong feeling that banks have benefited from the crisis and don't appear contrite, by rewarding themselves for failure. As one participant at the debate has put it: 'there is no humble pie and no humility'.

It is not only the banks themselves who have lost the trust of the public – the regulators have also lost the confidence of those who have been involved in the Big Banking Debate. Regulation was not sufficient and needs to improve, with a perceived lack of independence at the FSA with ex-bankers running it.

A lack of financial capability among the public has been seen to contribute to a loss of confidence in banking. One participant has suggested that incorporating financial education into the citizenship test – and into school curricula – may help ensure that the public is better placed and more confident to make the right financial decisions.

Impact of the crisis

These issues relate to people's overall experience of banking. However, in addition there are some specific issues raised with respect to the financial crisis. A number of consumers raised concerns about the impact that the banking crisis has had on them and people they know. People have witnessed the impact on small businesses, for example, with banks not lending and with an additional lack of flexibility towards business customers in terms of repayments on credit when times got tough. In addition, when it comes to individuals with credit cards, a number of people found that they had their cards withdrawn.

Perhaps one of the most significant impacts from the crisis that people have felt is the impact on interest rates, particularly those who rely on their savings to generate an income to live on. Many people have reported how their savings rates have been severely reduced, with one person querying the logic of certain ISA rates being lower than savings account rates. It was pointed out that as a result, people feel discouraged from saving at a time when they most need to. There is also a sense that people feel cheated, particularly if they have taken responsibility for trying to save and yet do not feel the benefits.

There is also a more general sense of a loss of trust and respect for banks as a result of the crisis. This, accompanied by a distinct level of uncertainty and pessimism about the future, has genuinely shocked the ordinary consumer and shaken people's confidence. Some even believe that the bailout by the taxpayer has led to a sense that banks are arrogant as they know they cannot fail. ■

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For more information about the work of the Future of Banking Commission, or to register your views please visit www.which.co.uk/banking