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Policy Paper

Banking in the public interest: *Progressive reform of the financial sector*

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Glossary

Basel Accords refer to international agreements on banking regulations supervised by the Basel Committee on Banking Supervision (BCBS). The Committee's Secretariat is based in Basel, Switzerland. The BCBS has representation from major countries, including the UK. Basel Accords are a series of recommendations on banking supervision, such as Basel I, II and III. Basel III mostly supersedes the previous accords and sets out rules on banking capital and liquidity. The key idea is to enhance the banking sector's ability to absorb shocks and improve risk management.

Collateralised debt obligations (CDOs) are financial products created by banks and resold to investors. These generally pool, or repackage, a variety of cash flow generating assets on a bank's books. The assets could be a variety of loans, mortgages, company bonds and credit card debt that require repayments. The mix of the repackaging creates different degrees of risks and thus tries to appeal to the risk preferences of investors. They are 'collateralised' because the promised payments of the variety of debts in the package provide the collateral, which gives the debt its value. Banks like CDOs because they enable them to raise cash flow and give out more loans, and also shift the risk of default from the banks to the investors holding the CDOs.

Derivative has been defined by the US Treasury as *"a financial contract whose value is derived from the performance of underlying market factors, such as interest rates, currency exchange rates, and commodity, credit, and equity prices. Derivative transactions include an assortment of financial contracts, including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof"*[1]. Derivatives have a **notional or face value**. This is the total value of the asset, at the current market (spot) price, against which a contract is written.

Leverage ratio relates to a company's method of financing its operations and generally indicates its ability to meet financial obligations or absorb shocks. The leverage ratios can be calculated in many ways. One example looks at the gross leverage ratio which highlights the extent to which a company's total assets are financed by long-term capital provided by shareholders equity. So, if a company has assets of £100 million and shareholders have provided capital of £10 million then the leverage ratio is 10%. The question then is whether the £10 million of capital is sufficient to absorb shocks arising from bad debts and poor investments. If not, then after the exhaustion of £10 million, the company will technically be bankrupt.

Executive summary

Six years after the 2008 banking crash, there have been some small tweaks, but little structural reform of the financial sector and nothing has been done to deal with the fundamental causes of the financial crisis. Organised gambling and anti-social practices by the banks undermined the stability of the entire economy, yet to all intents and purposes it remains business as usual for the financial elite. The state, most notably the US, has occasionally bitten back, but fines have just become another cost of doing business. Rear-guard action by financial elites to protect the selfish games of the banking sector has resulted in only paltry changes to regulation.

Neoliberalism, the dominant ideology since the 1970s, focuses on deregulation and the endless pursuit of private wealth. The corrosive effects of neoliberalist values have been most evident in the financial sector, where profits have been made from selling abusive financial products, money laundering, tax avoidance, sanction busting, speculation on commodities and land, takeovers and insider trading. There are no constraints on speculative activities and financiers routinely gamble ordinary people's savings and pensions on an unprecedented scale. This reckless gambling produces little, if any, real additional wealth, but its destructive effects have had serious consequences for the average household and the wider economy.

It is hard to find any major bank that did not seek to fill its coffers by abusive practices. When the crash landed, banks like Northern Rock, Bradford & Bingley, HBOS and Royal Bank of Scotland faced a liquidity crisis and the state stepped in to rescue them, pouring in billions to support the ailing industry. Neoliberalism has created perverse incentives for distortions in the financial sector where profits are privatised and losses are socialised. Contrary to neoliberal claims, the state has not been rolled-back, but instead has been absolutely central to the survival of the financial sector. The state has been restructured to support the corporate sector, and guarantee profits. It has bailed out banks and shielded them from public scrutiny. The state, rather than the market, has committed loans and guarantees of £977 billion[2] to support distressed banks; and under Quantitative Easing, the Bank of England has given £375 billion[3], about £16,000 per household to the banks. While 'nationalisation' has not been mentioned, the effects on the public purse are the same.

The financial sector has colonised the state in such a way that political power has been subordinated to corporate interests. Through their capture of the state, neoliberals have diluted, if not eliminated, the risk of business bankruptcy in the financial sector. For decades, the sector has been engaged in a series of malpractices, but has been bailed out. Its executives have inflicted enormous social harms through engaging in anti-social practices, but continue to collect massive remuneration packages. There is an urgent need for reforms that check the worst excesses of neoliberalism by strengthening democratic control and accountability in the banking sector.

This paper suggests a number of reforms:

1. Separate retail and speculative banking
2. Legislate for approval to be sought before investment banking can be financed with public funds
3. Restrict access to public courts for financial corporations
4. Introduce a financial transactions tax
5. Break the link between regulators and industry insiders
6. Emphasise public interest over market pressures
7. Publicise remuneration contracts
8. Make banks a central part of the community
9. Ensure greater transparency
10. Make tax returns public in order to tackle tax avoidance
11. End private auditing
12. Ensure regular reviews of the banking industry

On their own, they will not solve the deep-seated crisis in our financial sector, but they will provide an important starting point for long-term reform.

Chapter 1: Introduction

Historically, liberalism has been a mixed bag of ideas from the left and the right of the political spectrum. It encompassed progressive thinkers such as William Beveridge and John Maynard Keynes who envisaged constraints on the movement of capital and a key role for the state in redistributing wealth to create a more equitable and just society. However, since the 1970s, under the influence of writers such as Milton Freedman and Friedrich August von Hayek, liberalism has been rapidly displaced by neoliberalism. The neo or newer elements in this philosophy promote faith in free markets, privatisation of state-owned enterprises, mobility of capital and forms of regulation which emphasise light-touch regulation for financial markets and erosion of labour rights. The state, neoliberals argued, had to be rolled-back because it was inefficient and got in the way of self-correcting markets. Neoliberalism not only informed the economic and social policies of governments, but also provided everyday understandings of what it means to be successful. It reconstructed individuals as competitive beings engaged in the endless pursuit of private wealth and consumption, which would somehow lead to vast increases in new jobs, efficiency, affluence and happiness. Such ideologies were eagerly embraced by governments in the UK and USA and exported to other countries through foreign direct investment, trade agreements and financial institutions, such as the International Monetary Fund, the World Bank and the World Trade Organization.

A necessary condition for the operation of markets that work in the interest of society is that individuals need to be constrained in some way by social norms and regulatory structures. Such constraints induce stability, predictability and a sense of fairness that is so essential for any social system to work. This sense of social cohesiveness has been undermined by individualisation promoted by neoliberalism. The individualisation of society has created opportunities for making a fast buck with very few repercussions for deviant behaviour. Bending the rules for personal gain is often regarded as a sign of business acumen or as stealing a march on a competitor, rather than acting in a criminal way. Almost any trick is considered to be acceptable if it leads to personal enrichment.

The danger signs were evident well before the 2008 financial crash. A UK government investigation into share price rigging in 1997 concluded that too many executives at major corporations have a *"cynical disregard of laws and regulations ... cavalier*

misuse of company monies ... contempt for truth and common honesty. All these in a part of the City [of London] which was thought respectable"[4]. Still, governments even more vigorously promoted neoliberalism by allowing banks to gamble without any limits.

Prior to the Financial Services Act 1986, gambling debts were generally not enforceable in courts, but the government slipped in an amendment *"that for the first time ever said that the gaming laws of the land would not apply to these City gaming contracts"*[5]. The financial sector made vast profits from speculation on the price of wheat, housing, corn, copper, gas, electricity, mortgages, currencies and anything else that could be priced. The light-touch regulatory regime overseen by the grandees of the finance industry did nothing to stop the circus of speculation, mostly with other people's monies.

The move away from traditional banking to speculative banking changed the nature of banks. In 1969, retail deposits accounted for 88% of bank liabilities but by 2009, they stood at just 40%[6], and indicated that banks have moved away from their traditional role and become firmly embedded in speculative practices. On the back of unrestrained gambling and merger mania, banks became too big and perhaps too important to fail. Of course, organisations can go bankrupt, but because banking operations are intertwined with the rest of the economy, politicians felt that the sector could not be permitted to collapse. The too-important-to-fail syndrome meant that banks no longer cared about the social consequences or even their own survival, as the cost of failures would be picked up by someone else. Some people made vast amounts of money, but it all tumbled down with the financial crash of 2007-2008 and inflicted hardship upon millions of people.

Chapter 2: The impact of neoliberal culture on the finance sector

The corrosive effects of neoliberalist values have been most evident in the financial sector, a champion of deregulation and free markets. It has made huge profits from money laundering, tax avoidance, sanction busting, speculation on the price of commodities and insider trading. In an environment of poor regulation, the mid-1970s secondary banking crash spread to insurance, property and other sectors. The government bailed out companies and had to negotiate a loan from the International Monetary Fund (IMF). In subsequent decades, the financial sector sold predatory financial products relating to pensions, endowment mortgages, precipice bonds, split capital investment trusts and payment protection insurance. These products were designed and marketed by executives whose remuneration was linked to profits. Staff were trained to sell them to unsuspecting customers, with the promise of higher financial rewards. Markets lauded companies for their high profits and dividends, but did not ask any questions about the quality of profits. Regulators simply looked on. Despite having a plethora of non-executive directors, audit committees, ethics committees and eminent accounting firms as auditors, there was no disclosure of any of the shady practices.

In 1984, Johnson Matthey Bank collapsed under the weight of fraud and the Bank of England organised a rescue. In 1995, Barings Bank collapsed due to fraud. The twentieth century's biggest banking frauds took place at the Bank of Credit and Commerce International (BCCI). In July 1991, the Bank of England closed BCCI. Some 1.4 million depositors lost some part of their savings. However, unlike the previous banking collapses, no government inspectors have been appointed to investigate the BCCI frauds. A US Senate investigation into the frauds at BCCI concluded that British regulators and bank auditors had become *"partners, not in crime, but in cover up"*[7]. In 1992, Lord Justice Bingham[8] was asked to examine the failure of the Bank of England to effectively supervise BCCI operations, but his report has not been published in full[9] as successive governments sought to protect the identity of key players. After a freedom of information dispute lasting five and a half years, in 2011, the courts ordered[10] the UK government to release one secret report, codenamed the Sandstorm Report[11], on BCCI frauds which names the parties looting the bank. HM Treasury website still does not show this document.

The mid-1970s banking crash showed that banks must have adequate capital to

absorb shocks caused by market volatility and investments going sour. As a banking crash can bring the whole economy down, it is vital that external regulators scrutinise the bank's own assessment of risks and determine the capital that is needed. However, that is not what happened in the run-up to the 2008 financial crash. Following the Basel II accord (see glossary), from 2004 onwards, regulators decided to rely on risk assessment models developed by banks themselves with the help of credit rating agencies. These were based on numerous assumptions about market prices and the presence of buyers and sellers, and could not easily be verified. Nevertheless, banks were permitted to move large amounts of collateralized debt obligations (CDOs) off their balance sheets (see glossary). More than $5,000 billion (£3.125 billion) of assets and liabilities were not reported in bank balance sheets[12]. Some $1.2 trillion (£750 billion) of bad debts and toxic assets were shown as good assets by banks[13]. This should have been a cue for auditors to raise red flags, but they did not. Almost all distressed banks received the customary clean bill of health from their auditors[14] even though at one stage, the UK's Chancellor of the Exchequer felt the country was just two hours away from a financial meltdown[15].

Banks had little idea of their overall risks, assets and debts, but the financial engineering described above allowed them to show artificially high amounts of capital in their balance sheets. Stock markets wanted a slice of that in the form of higher dividends. In 2007, the Financial Services Authority (FSA) gave Northern Rock a waiver from the Basel II requirements. A subsequent hearing by the UK House of Commons Treasury committee noted[16] that "*due to this approval, Northern Rock felt able to announce on 25 July 2007 an increase in its interim dividend[17] of 30.3%. This was because the waiver and other asset realisations meant that Northern Rock had an anticipated regulatory capital surplus over the next 3 to 4 years*". Within days, Northern Rock faced a cash flow crisis as the market for mortgage-backed securities collapsed, and it could not continue to repackage the mortgages and sell them immediately to raise cash. Anxious savers formed queues outside branches to retrieve their savings and the UK faced its first bank run since 1866. The neoliberal state rescued and, subsequently, nationalised the bank. This was followed by the nationalisation of Bradford & Bingley, Royal Bank of Scotland (RBS) and the state-sponsored rescue of HBOS by Lloyds amongst others. The state also poured in billions to support the ailing financial sector.

Banks must have adequate capital to meet any shocks, but under the weight of corporate power, regulators continue to be persuaded that this needs to be as small

as possible. Just before the crash, Bear Stearns had some $11 billion (£6.9 billion) in equity and $395 billion (£247 billion) of assets, most of which could not easily be turned into cash to meet its obligations[18]. The bank had a leverage ratio of over 35 to 1 ($395 billion/$11 billion) and could barely absorb a decline of around 3% in its assets. Lehman Brothers had a leverage ratio of more than 30 to 1[19]. With this leverage, a 3.3% drop in the value of assets would wipe out the entire value of equity and make the bank technically insolvent. RBS had an even lower leverage ratio of just 2%. Rather than requiring banks to restrain executive pay and dividends to build their capital base, the latest Basel accord requires them to have a leverage ratio of only 3% [20]. Despite the crash, regulators continue to trust banks' own risk-assessment models, which have already failed. Lloyds Banking Group claims to have some £143 billion of high quality mortgages on its books and in accordance with the current rules, it holds just £314 million of capital to cover the specific risks[22]. This means that Lloyds has lent some 455 times the capital earmarked to absorb the losses. It would only take a default rate of 0.2% for the entire capital of £314 million to be wiped out.

Taking advantage of lax regulation and enforcement

In pursuit of higher corporate profits and performance-related remuneration, banks have scaled new heights in predatory practices. For example:

- RBS and Société Générale, JP Morgan and Citigroup have been fined €1.71 billion (£.142 billion) for participating in illegal cartels[22] in markets for financial derivatives by fixing the London Interbank Offered Rate (LIBOR) and the Euro Interbank Offered Rate (EURIBOR).
- UBS has agreed to pay $1.5 billion (£940 million) to US, UK and Swiss regulators for attempting to manipulate the LIBOR interbank lending rate[23].
- Following a $187 billion bailout of mortgage guarantee firms Fannie Mae and Freddie Mac, the US Federal Housing Finance Agency has sued a number of banks for making misleading statements relating to the sale of around $200 billion in mortgage-backed securities. In February 2014, Morgan Stanley settled by agreeing to pay $1.25 billion[24] (£765.5 million). Previously, JP Morgan Chase paid $13 billion (£8.1 billion)[25] and Deutsche Bank paid $1.925 billion (£1.2 billion)[26] to settle the charges. A number of other banks, including Barclays Bank, Citigroup, Credit Suisse, Goldman Sachs, HSBC and RBS, have also been sued[27].

- The US Securities and Exchange Commission (SEC) has fined Goldman Sachs $550 million (£344 million) for misleading investors in a subprime mortgage product[28].

- In July 2013, the US Federal Energy Regulatory Commission fined Barclays Bank $470 million (£294 million)[29] for the manipulation of electricity prices by its derivative traders.

- The Lloyds Banking Group was fined over £28 million for promoting a culture of selling abusive financial products[30].

- HSBC was fined $1.9 billion (£1.19 billion) for facilitating money laundering by terrorists and drug kingpins[31].

- Standard Chartered paid a fine of over $300 million (£188 million) for money laundering and sanction busting[32].

- The European Union is investigating the Bank of America, Merrill Lynch, Barclays, Bear Stearns (now part of JP Morgan), BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Morgan Stanley, UBS and RBS for possible abuses in price fixing of Credit Default Swaps (CDS)[33].

- A former Goldman Sachs director has been found guilty[34] of providing insider information to a hedge fund manager.

The above examples are the tip of the iceberg, and provide a glimpse of malpractices carefully manufactured in banking boardrooms by smart, wealthy and highly educated individuals.

Large-scale tax avoidance

Tax avoidance has been added to the financial sectors' portfolio of deviant practices:

- A US Senate Committee[35] reported that Deutsche Bank, HVB, UBS, and NatWest colluded with major accountancy firms to construct orchestrated transactions to enable their wealthy clients to avoid taxes.

- In February 2009, the US Department levied a fine of $780 million (£488 billion) on UBS to settle charges of defrauding the government of tax revenues[36]. In 2013, UBS was fined €10 million (£8.5 million) by the French

authorities for helping wealthy clients to open undeclared bank accounts in Switzerland and avoid taxes in France[37].

- RBS had stashed some £25 billion of its cash in tax havens, which could have deprived the UK of £500 million of tax revenues[38]. The bank has been accused of engaging in complex transactions to avoid tax on profits of £3.8 billion from the sale of various bonds[39]. In January 2014, a number of former RBS bankers were arrested and charged with using a film-production scheme to avoid £2.5 million in taxes[40].

- Barclays Bank has been under public scrutiny because of the mismatch between its profits and taxes. For the years 2010, 2011 and 2012, Barclays reported pre-tax profits of £5.7 billion, £3.2 billion and £4.8 billion respectively. The headline corporation tax rates for these years were 28%, 26% and 24% respectively. The bank actually paid UK taxes of £147 million in 2010, £296 million in 2011 and £82 million in 2012[41]. One of the reasons for the mismatch between profits and tax is that Barclays had an internal division which was set targets to avoid taxes, and its staff were incentivised to meet those targets. This division generated revenues of more than £1 billion a year between 2007 and 2010. One of its roles was to craft tax avoidance schemes. In 2012, the UK government took the rather unusual step of introducing retrospective legislation to block two of its tax avoidance schemes, which could have enabled Barclays and/or its clients to avoid around £500 million of UK corporation tax[42]. HM Treasury's press release referred to both schemes as *"highly abusive"* and *"designed to work around legislation that has been introduced in the past to block similar attempts at tax avoidance"*[43].

- A 2013 US court judgment showed that Barclays collaborated with accountancy firm KPMG to market tax avoidance schemes to major corporations, including AIG, Microsoft, Intel and Prudential. After examining some 1,250 exhibits, the judge declared the scheme to be unlawful and said[44] that it is an *"abusive tax avoidance scheme. … The conduct of those persons from … Barclays, KPMG … who were involved in this and other transactions was nothing short of reprehensible".*

It is hard to find any major bank that did not seek to fill its coffers through abusive practices.

Chapter 3: Derivatives - the elephant in the room

Since the 1970s there has been an explosion in the trade in derivatives. Companies pretend that it is all about risk-management, but most of this trade consists of naked gambling, usually with other people's monies. The gambling is akin to someone placing a bet on racehorses. Of course, the financial horses can't and don't always win. Derivatives have been described by investment guru Warren Buffett as *"financial weapons of mass destruction"*[45]. Bankers bet on anything that can be priced – copper, wheat, cotton, corn, tin, gold, currencies and anything else. The hard cash needed to settle the outcome of these bets is always highly uncertain until the contracts mature, which could be 10 to 15 years in the future. The UK Treasury does not even hold any meaningful data about the exposure of UK banks[46], but the information released by the Bank of International Settlements (BIS) shows that in June 2013 the global notional/face value of Over-the-Counter (OTC) derivatives was about $693 trillion[47]. Over-the-Counter means that the securities are not traded on recognised exchange. They are bilateral contracts between financial institutions and other corporations. Each party relies on the other to perform its part of the contract. This means that the failure of one financial institution will have a knock-on effect on others. In addition, some derivatives are traded on recognised stock exchanges and may have a notional value of $70 trillion[48], making a total of $763 trillion (£477 trillion). Even now a lot of data is missing or incomplete and some think that the grand total could be $1200 trillion (£750 trillion)[49]. The actual economic exposure is unknown, but some estimates put it at around $20 trillion (£12.5 trillion). The global GDP is around $75 trillion (£47 trillion), and it is unlikely that any government will be in a position to contain the impact of financial meltdown.

The UK's GDP is around £1.5 trillion. The entire UK household wealth at the end of 2012 was estimated to be about £7.3 trillion[50]. Against this background, just three UK banks – Barclays, HSBC and RBS alone – have a derivatives portfolio, with a face value totalling nearly £100 trillion. Barclays leads the way with £40.5 trillion, though the actual exposure is hard to judge. Its 2012 balance sheet showed derivative assets of £469 billion and derivatives liabilities of £462 billion. The assets and liabilities are not necessarily directly offset as the direction of exposure cannot be guaranteed. So the exposure could be over £900 billion, some 60% of the UK GDP. The total capital of the worldwide operations of Barclays Bank is only £63 billion. The total global capital of HSBC, the UK's largest bank, is $183 billion (£114 billion). Its 2012 balance sheet

shows derivatives assets of $357 billion (£223 billion) and derivatives liabilities of $359 billion (£224 billion). So, depending on events, the exposure could be over $700 billion (£447 billion). Derivatives were behind the demise of Barings, Lehman Brothers, Northern Rock, Bear Stearns, MF Global, Countrywide, Merrill Lynch, Wachovia and Washington Mutual, just to mention a few. Société Générale trader Jerome Kerviel was considered to be one of the best risk managers in the world, but his bets on stock index futures went sour and caused the bank to report a loss of €4.9 billion (£4 billion) in 2008[51]. This dwarfed the $6 billion (£3.75 billion)[52] loss on natural gas futures by Amarnath Advisors in 2006, and Sumitomo copper futures loss of $2.6 billion (£1.6 billion)[53] in 1996.

Even Nobel Prize winners in economics have been unable to manage derivatives. In 1997, US economists Myron Scholes and Robert Merton shared the Nobel Prize in Economics *"for a new method to determine the value of derivatives"*. Their mathematical models enabled them to make huge profits through Long-Term Capital Management (LTCM), a hedge fund[54]. However, just seven months after receiving their Nobel Prize, their models were in trouble. At one stage, LTCM had capital of only $4.72 billion, but borrowed $124.5 billion and thus tied numerous other banks to its risky positions. In 1997-98, LTCM misjudged the severity of the East Asian and Russian financial crisis and found itself with $400 million of capital, $100 billion of debts, $4.5 billion of losses and derivatives with a face value of $1 trillion. The US government persuaded a consortium of banks to rescue it.

This massive gambling produces little, if any, additional real wealth, but its destructive effects have continued. In 2007, Northern Rock had derivatives with a face value of £125 billion. It had opaque corporate structures and held some $50 billion of debt in Granite Master Issuer Inc., a specially created entity in the tax haven of Jersey, supposedly a charitable trust. Granite had hardly any employees, but was used by Northern Rock to sell bundles of its mortgages and obfuscate its financial risks. In 2008, Lehman Brothers collapsed with 1.2 million derivatives contracts which had a face value of nearly $39 trillion (£24.4 trillion), though the economic exposure was considerably less. Its balance sheet boasted net derivatives assets of $22.2 billion (£14 billion), which turned out be equivalent to the bookies receipts. As the financial horses did not reach the winning post, all of this became worthless junk and it faced claims from counter parties for payment of $300 billion (£188 billion). For nearly six years before its demise, almost all of the pre-tax profits at Bear Stearns came from speculative activities. It could not continue to pick

winners indefinitely and collapsed in 2008. It had shareholder funds of $11.8 billion (£7.4 billion), debts of $384 billion (£240 billion) and a derivatives portfolio with a face value of $13.4 trillion (£8.4 trillion). In October 2011, MF Global, the US brokerage firm which specialised in delivering trading and hedging solutions, filed for bankruptcy. It had nearly three million derivatives contracts with a notional value of over $100 billion (£63 billion).

This reckless gambling has serious consequences for the average household. In 2012, Goldman Sachs (a bank bailed out by the US taxpayers) made an estimated $400 million (£251 million) from speculating on the price of essential foods, such as wheat, maize, coffee and sugar[55]. The World Bank estimated that in 2010, 44 million people were pushed into poverty because of high food prices. In one day in 2010, JP Morgan bought up between “50% and 80%” of the world reserve of 350,000 tons of copper[56]. The bank was not interested in mining, processing, using copper, taking its delivery or selling it. Its interest was simply to speculate, create frenzy and make a quick profit, which it did.

Despite all the evidence, the finance industry remains addicted to derivatives, and regulators have shown little urgency in curtailing that addiction. The Senior Supervisors Group, which includes the UK’s Prudential Regulatory Authority, has said that *“Five years after the financial crisis, firms’ progress towards consistent, timely, and accurate reporting of top counterparty exposures fails to meet both supervisory expectations and industry self-identified best practices”*[57]. So some six years after the crash, bankers are still gambling other people’s monies, governments don’t have the data to estimate, far less control, the risks; and regulators are operating blindly, leading us to the next crash.

Chapter 4: Business as usual for the banking sector

Contrary to neoliberal claims, the state has not been rolled-back. Instead it has been restructured. It is not so concerned about the redistribution of income and wealth, labour rights, or the provision of decent healthcare, education, pensions and social infrastructure. In keeping with neoliberal ideology, the state has shunned pluralist policymaking apparatuses. Instead, corporate elites have been elevated to public policymaking bodies and the state's major purpose is now to guarantee corporate profits. The state has become the underwriter of the financial sector. It has bailed out banks and shielded them from public scrutiny (see the reference to BCCI in Chapter 2). The word 'nationalisation' has not been mentioned, but the effects on the public purse are the same. The state, rather than the market, has committed loans and guarantees of £977 billion[58] to support distressed banks. The government is paying some £5 billion a year in interest alone, about the cost of building 500 new schools, on the borrowing raised to finance the purchase of shares and loans to banks[59].

Under its quantitative easing programme, printing money as old-fashioned economists used to call it, the Bank of England has given £375 billion[60], about £16,000 per household to the banks. This money has not been used to provide loans to small and medium-sized businesses to enable them to reinvigorate the economy. Most of it has been used to reduce toxic assets and bolster bank balance sheets. Confidence in the banking sector is maintained through the provision of a taxpayer funded depositor protection scheme which safeguards savings of individuals of up to £85,000. Since March 2009, the state has maintained interest rates at 0.5%, considerably below the rate of inflation. This has robbed pensioners and savers of income and also eroded the real value of savings. The policy has enabled banks to borrow at ultra-cheap rates, lend money at high rates, make profits and replenish their balance sheets. The customer base for banks has swelled as the government has persuaded pensioners and social security claimants to receive their payments through bank accounts rather than through the Post Office.

The state has guaranteed profits to the finance industry in numerous other ways, too. A good example of this is the Private Finance Initiative (PFI), launched by the Tories in the early 1990s, and expanded by the Labour government from 1997 to 2010. Under the PFI schemes, private corporations, with support from banks,

provide schools, hospitals, roads, solar energy, waste and defence equipment. These are effectively leased to the government who guarantees profits for banks and corporations though annual payments. In 2012, some 717 PFI contracts with a capital value of £54.7 billion were running. In return, despite record low interest rates, the government is committed to repaying £301 billion[61]. That is a profit of £247 billion for banks and corporations over the next 25-30 years. For example, RBS is the beneficiary of a £6 billion project to supply search and rescue helicopters to the government[62]. HICL Infrastructure is a fund established by HSBC and registered in Guernsey. Its portfolio of PFI projects includes Portsmouth Hospital and the John Radcliffe Hospital in Oxford. For 2011, it is estimated to have made a profit of £38 million from 33 PFI schemes, but paid only £100,000 in UK tax[63], equivalent to about 0.25%.

The above are not the only examples of the way neoliberals have mobilised the state to maximise private profits. For example, the state has created pseudo-markets for corporations to exploit in land, gas, electricity, water, transport, healthcare, education, prisons, security and even pollution. Through their capture of the state, neoliberals have diluted, if not eliminated, the risk of business bankruptcy in the financial sector. They can gamble with other people's savings and pensions. If their gambles pay-off, they collect large pay packets. If they don't, then the state bails them out and ordinary people lose the value of their savings. There is no personal responsibility, liability or any other consequence. No market has ever penalised directors for such predatory practices. On the contrary, they are rewarded with high remuneration packages.

- For the four years to 2012-13, the average pay of FTSE 100 directors rose by 13.6% to £1.45 million, which is about three times the increase in average earnings for the same period[64].
- The post-crash City bonus pool is expected to top £80 billion[65].
- For 2012, the average remuneration of a chief executive at 15 leading US and European banks was $11.5 million (£7.19 million)[66].
- HSBC's chief executive received a remuneration package of £7.4 million whilst many front line staff in branches earned around £14,000 a year.
- The CEO of Lloyds Banking Group received £3.8 million in 2012.

- At RBS, eight senior executives collected £21 million; in fact, 95 collected more than £1 million each[67].
- More than 3,500 EU bankers were paid more than €1 million in 2013, of which 75 percent are based in the UK[68].
- At Goldman Sachs, 115 senior staff in London received an average pay packet of £2.7 million in 2012, a 50% rise.
- At Barclays, 393 executives received an average of £1.3 million and for years, its former executive, Bob Diamond collected in excess of £20 million annually.
- The beleaguered RBS paid an average of £701,000 to its 368 executives[69].
- Despite all the fines for dubious practices, the chief executive of JP Morgan Chase collected a remuneration package of $20 million (£12.5 million) for 2013[70].

No executive or shareholder has offered their gains to innocent victims of their predatory practices. No shareholder has given the dividends from predatory practices to the victims. The state, most notably the US, has occasionally bitten back, but fines have just become another cost of doing business. They have been passed to customers in the form of higher charges for loans and overdrafts.

Chapter 5: Short-termism and maximising shareholder profits

Some six years after the financial crash, there has been little fundamental reform of the financial sector. Financiers continue to gamble ordinary people's savings and pensions. After examining the debacles at HBOS, the UK Parliamentary Commission on Banking Standards concluded that *"prudential supervisors cannot rely on financial markets to do their work for them. In the case of HBOS, neither shareholders nor ratings agencies exerted the effective pressure that might have acted as a constraint upon the flawed strategy of the bank"*[71]. The interests of shareholders and society cannot be aligned as shareholders push directors to take even higher risks and extract as much cash as possible in the shortest possible time. The Commission on Banking Standards subsequently concluded that *"shareholders failed to control risk-taking in banks, and indeed were criticising some for excessive conservatism"*[72]. Financial elites don't want to hear any of this, and are engaged in a rear-guard action to protect their self-interested games. The main message of the Treasury reports by Sir David Walker[73] and Sir Winfried Bischoff[74] is to trust the markets, leave it to directors and voluntary and unenforceable corporate governance codes. Apparently, all that is needed is further empowerment of shareholders to shackle directors and rely on markets to put neoliberalism back on the yellow brick road, even though they have shown little interest in doing so.

Table 1 Shareholders' Equity and Total Capital in UK Banks

Company	Year	(1) Gross Assets (Million)	(1) Shareholder Equity (Million)	% Provided by Shareholders
Barclays	2012	£1,490,321	£ 62,957	4.22
HSBC	2012	$2,692,538	$183,129	6.80
(2) Lloyds Banking Group	2012	£ 924,552	£ 44,684	4.83
(3) Royal Bank of Scotland	2012	£1,312,295	£ 70,448	5.37
(4) Santander	2012	€1,269,628	€ 84,326	6.64
Standard Chartered	2012	$ 636,518	$ 46,055	7.24

Notes: (1) Information as per audited balance sheets published by companies. (2) Lloyds Banking Group includes Lloyds Bank, Halifax Bank of Scotland, TSB, Scottish Widows and Birmingham Midshires. (3) Royal Bank of Scotland Group includes The Royal Bank of Scotland, National Westminster Bank, Ulster Bank, Citizens Financial Group, Charter One, Coutts Bank, RBS Securities, Isle of Man Bank, Dam and company, Churchill, Green Flag, Direct Line, Privilege and Lombard. (4) Santander is registered in Spain and has a presence in the UK. It has also absorbed some well-known UK names, such as Abbey National, Alliance and Leicester, and Bradford & Bingley.

Andy Haldane, Executive Director for Financial Stability at the Bank of England, has stated that the average duration of shareholdings in the US, UK and European banks *"fell from around 3 years in 1998 to around 3 months in 2008. Banking became quite literally, quarterly capitalism"*[94]. The position of shareholders is no different from that of a trader or a speculator. Shareholders provide a very small proportion of the risk capital of banks, as evidenced in Table 1.

The proportion of capital provided by shareholders to major UK banks is, even by very generous standards of measurement, between 4.22% and 7.24% of their total assets. Most of the resources are provided by savers and other creditors, and bailouts have been funded by the public at large. Altogether, savers, borrowers and employees have a long-term interest in the operations of banks. However, there are no government proposals to empower these groups to direct banks and hold directors to account. Somewhat mutedly, the Banking Standards Commission has recommended that the Government consult on a proposal to amend section 172 of the Companies Act 2006[95] to remove shareholder primacy in respect of banks, requiring directors of banks to ensure the financial safety and soundness of the company ahead of the interests of its members[96]. Needless to say, the government ignored such proposals in the Financial Services (Banking Reform) Act 2013 which does little to address the fundamental issues.

Chapter 6: Reform - for a banking sector that works in the public interest

The neoliberal experiment has been a social disaster. The financial sector has been indulged through lax regulation and enforcement, and billions of pounds in bailouts, loans and subsidies. But it has delivered so little. In its boom years, between 2002 and 2007, the financial sector paid £203 billion in UK corporation tax, national insurance, VAT, payroll taxes, stamp duty and insurance taxes[78]. This is about half of that paid by the manufacturing sector. In the subsequent six years, the taxpayer has poured in nearly £1 trillion to rescue the financial sector through bailouts, loans, guaranties and subsidies. The cost to society is a deep recession, loss of jobs and GDP, destruction of people's savings and a massive diversion of capital, which could have been used for more productive purposes. No society can afford a repeat of this economic bargain. Contrary to the neoliberal claims, the financial sector has hardly created any new jobs. Between 1991 and 2007, direct employment in the banking and financial services sector increased by only 35,370 to 1,054,084, or about 3.5% of the UK work force[79]. Despite its poor social performance, the financial sector has extracted immense volumes of cash from the market. For the period 1998-2008, some 60% of the rise in income share of the top decile accrued to finance workers, mostly to relatively few executives and traders[80]. So, the finance industry has exacerbated social inequalities.

Neoliberalism has created perverse incentives for distortions in the financial sector where profits are privatised and losses are socialised. Organised gambling and anti-social practices have undermined the stability of the entire economy. The financial sector has never been independent of the state, but has colonised the state in such a way that political power has been subordinated to corporate interests. Reforms need to be based on democracy and must rollback the worst aspects of neoliberalism. The following reforms will begin that work.

1. **Separate retail and speculative banking**

   In contrast to the Financial Services (Banking Reform) Act, there must be a legally enforceable separation between retail and speculative banking. This would help to contain the toxic effects of future crises. However, merely separating the banking arms is not enough because speculators would

continue to be funded by monies from savers, pension funds and insurance companies to finance their gambling habits. By enjoying the benefit of limited liability, they will be able to dump their losses onto the rest of society and affect innocent bystanders. This should be addressed by withdrawing the privilege of limited liability from speculative activities, and holding the owners of entities personally liable for the debts of their organisations. The regulators would need to invigilate speculative banking to ensure that gambles are matched by available capital.

2. Legislate for approval to be sought before investment banking can be financed with public funds

To prevent innocent bystanders from being caught in the negative consequences of speculative activities, legislation should be enacted to ensure that no retail bank, insurance company or pension fund is able to provide any finance to investment banking without express approval from those directly affected.

3. Restrict access to public courts

Speculative banking should be denied access to publicly funded courts. Speculative banking covers large amounts and many counterparties. The practices add little economic value, if any, but disputes amongst reckless risk-takers can last for years and would force taxpayers to bear the cost. This should be changed by legislation which makes certain financial contracts unenforceable through the courts.

4. Introduce a financial transactions tax

There should be a moderate financial transactions tax on certain financial transactions. This would help broaden the tax base and generate tax revenues to fund regulation of the financial sector to save it from its own follies. A progressive rate of tax can also discourage speculative flows to tax havens and secrecy jurisdictions which undermine much needed financial stability and tax revenues.

5. Break the link between regulators and industry insiders

For far too long, UK banking regulation has suffered from revolving doors whereby financial insiders become regulators and vice-versa. They have been

too close to the values, vocabularies and agendas of the industry and have failed to attach proper weight to the interests of other stakeholders. This vicious circle needs to be broken. The main priority of any regulator should be to protect the financial system and the individual consumer and this cannot be done unless there is some ideological distance between the industry and the regulator. The regulator needs to be advised by a Board of Stakeholders, representing a plurality of interests. This Board should not be dominated by the finance industry. In fact, only a minority shall come from the industry, thus ensuring that other voices are heard and policies are made by consensus. Its meetings would be held in the open and its minutes and working papers would be publicly available.

6. Emphasise public interest over market pressures

Retail banks should be freed from incessant pressures from stock markets for ever rising profits, a major cause of many banking scandals and the financial crash. Market pressures should be replaced by community pressures by turning them into co-operatives, mutuals, and employee- and state-owned enterprises. Retail banks should only be permitted to invest in securities specified by the regulators. These would primarily be low to medium risk securities. They should not be allowed to launch any financial product without express approval from the regulator. All evidence provided to secure such permission should be publicly available.

7. Publicise remuneration contracts

The executive remuneration contracts at all banks should be publically available. Employees, borrowers and lenders at all licensed banks should be empowered to elect directors and have a binding vote on all aspects of executive remuneration. Bank executives should receive a basic salary, subject to approval by stakeholders. Additional bonuses or incentives, if any, should require a binding vote from employees, borrowers and savers. The incentives should be linked to matters which emphasise long-term factors, such as freedom from scandals, service to the community, maintaining branch networks, consumer satisfaction, loans to small businesses, universal and fair access to finance, innovation and investment. The bonuses, if awarded, would be payable after five years and the agreements should contain clauses for claw-backs in the case of subsequent negative revelations.

8. Make banks a central part of the community

Banks should be part of local communities. They should not be permitted to up sticks and leave local communities in the lurch. Maintaining a socially desirable network of branches should be a necessary quid pro quo for a deposit-taking licence and the state's deposit protection guarantee. Each branch closure must be sanctioned by the regulator, and banks must be required to demonstrate that after closure, the local community's access to banking services will not suffer.

9. Ensure greater transparency

Banks must not be permitted to obfuscate their accountability by hiding behind offshore operations or spurious special purpose vehicles. Each direct or indirect offshore excursion must be specifically approved by the regulator. Complete details must be provided and a report showing their assets, liabilities, profits, losses, capital, taxes and employees in each jurisdiction of their operations must be published.

10.Make tax returns public in order to tackle tax avoidance

Banks have been significant players in the tax avoidance industry and have also avoided taxes on their own profits. This should be checked by making their tax returns publicly available so that the people can scrutinise them and alert the understaffed tax authorities. This would empower stakeholders to ask searching questions at annual general meetings and enable them to decide whether a bank is ethical. Banks should be required to publish complete details of tax avoidance, for themselves or their clients, facilitated through their operations.

11.End private auditing

Almost all banks are audited by just four global accountancy firms. They enjoy the state guaranteed market of external auditing, but have always failed to highlight frauds, fiddles and risks. Despite queues outside Northern Rock and the demise of many banks, all distressed major banks received a clean bill of health from PricewaterhouseCoopers, Deloitte & Touche, KPMG and Ernst & Young. This private police force of capitalism is primarily concerned about its own profits and uses auditing as a stall for selling other services, including tax avoidance. It has a history of silence and is immersed in too many conflicts of

interests, as evidenced by its silence at Barings, BCCI, the mid-1970s banking crash and other debacles. Accounting firms have shown no interest in serving the public or the state. The audits of all banks should be carried out on a real-time basis directly by the regulator, or an agency specifically created for that purpose. This would enhance the regulator's knowledge base and capacity for timely interventions. In the era of instant movement of money, ex-post audits are of little use. We have many types of audits, such as immigration checks at ports, checks on health and safety, fire safety and food hygiene, and they are all carried out by auditors who are neither hired nor remunerated by auditees. These auditors don't use audit as a stall to sell consultancy, and their files are available to law enforcement agencies. Bank auditors should not be an exception to this.

12. Ensure regular reviews of the banking industry

The House of Commons Treasury Committee should hold an annual hearing into banking regulation to ensure that regulators are diligently and effectively performing their tasks.

The above reforms are not a silver bullet, but will help to rollback the worst of neoliberalism. Parliamentary committees and influential commentators have drawn attention to the destructive effects of neoliberal ideology. Banks, like other major corporations, need to function as communities promoting and protecting the interests of ordinary people, rather than as private fiefdoms of self-interested executives and financial wheeler-dealers. The most effective reform is public sunlight, empowerment of community and democratic accountability, all of which have been lacking in the neoliberal era. The government needs to listen to the voices of the people who have seen the state become a bulwark of corporate interests, and address the democratic deficit. Ordinary people have borne the cost of predatory practices, but still have no say in how the financial industry is run.

Albert Einstein is credited with saying that insanity is doing the same thing over and over again and expecting different results. So it is in the financial sector. Despite the banking crash, vast public debt, the decimation of people's savings, loss of jobs and the never-ending tide of sleaze, the government still has faith in self-correcting markets, shareholders, credit rating agencies, dubious models of risk assessment, unrestrained gambling and banking elites functioning as regulators. There is an old adage that those who don't learn from history are destined to repeat it.

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