The **Financial Inclusion Centre**

www.inclusioncentre.org.uk

Commissioned by Unite the union

REFORMING THE FINANCIAL SYSTEM

EXECUTIVE SUMMARY

The speed and brutality with which the financial crisis has turned into a full scale recession is alarming. As we enter a new era of uncertainty the most vulnerable in society pay a high price with the prospect of home repossessions similar to early 1990's levels.

Financial exclusion - which affects millions of consumers – will deteriorate with more denied access to basic banking services or pushed into the hands of sub-prime lenders or loan sharks.

The reckless behaviour of financial institutions has put at risk the savings, investments and pensions, and jobs of millions of citizens.

The UK financial services sector is particularly affected and ordinary employees (who never had the safety net of high salaries or bonuses to fall back on) suffer most. The 'real economy' is hit with reduced access to credit and long term risk capital to invest sustainably for the future.

Unite the union commissioned The Financial Inclusion Centre to develop proposals for reforming the financial system. The Centre analysed the causes of the crisis and sought views of opinion formers.

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REFORMING THE FINANCIAL SYSTEM

There is justified anger that powerful financial institutions have undermined our economic welfare. The financial system needs to be reformed so it meets the needs of society and to reduce the risk of a similar crisis recurring. Tinkering with the system is not an option. The Centre has proposed a set of radical, but pragmatic and necessary reforms that address the root causes of the financial crisis. Details of the proposals can be found in the main report. The proposals have five strands: international regulatory reform; regulatory accountability; a new approach to regulation; governance of financial institutions and the role of long term investors; and longer term bank reform.

1. A NEW REGULATORY ARCHITECTURE

We make a number of proposals to improve i) financial stability (1); ii) prudential regulation of financial institutions (2); and iii) retail financial services regulation (3). The global nature of financial markets means that a narrow, national approach to financial regulation cannot work. We propose the establishment of a new International Financial Stability Agency (IFSA) to promote financial stability, and coordinate the prevention and resolution of global financial crises, and an International Financial Regulatory Agency (IFRA) to set and coordinate prudential standards for financial institutions at international level. There should also be a new European Financial Stability Agency (EFSA) and European Financial Regulatory Authority (EFRA) to perform similar roles at EU level and regulate financial institutions with significant cross border activities. Supervision of UK financial institutions should remain with FSA. At UK level, the relationships between the Bank of England, FSA and OFT need to be clarified. The Bank of England should have lead responsibility for financial stability, regulating exchanges, and wholesale market activities. The FSA should be the lead consumer protection authority. The OFT should focus on competition matters.

2. ACCOUNTABILITY OF REGULATORS

The democratic deficit at the heart of the financial system is shocking. Industry lobbies have far too much power and influence. Most of the FSA's board members have a financial services background, none are consumer or employee representatives (4). The Government should ensure that at least one-third of FSA board members are dedicated public interest representatives (5) eventually moving to half of board members. One third of the members of the Court of the Bank of England should be public interest representatives. No more than one-third of the FSA and the Court should have a financial services background. The FSA and the Bank of England should be required to answer to annual public hearings.

1) This is known as macro-regulation in policymaking circles

2) This is known as micro-prudential regulation

3) How financial institutions treat customers.

4) Nine have a financial services background, two are from other industry sectors, two are career regulators.

5) ie. a consumer or employee representative

3. A NEW APPROACH TO REGULATION

Regulators must become more robust, act as agents of society and avoid capture by industry lobbies and market orthodoxy. Robust regulatory standards must apply to all financial institutions, products, and jurisdictions to promote confidence, create a level playing field, avoid regulatory arbitrage, and control the shadow banking system (6). New measures are needed to deal with remuneration policies (7) that cause conflicts of interest between shareholders, firms, employees and consumers and encourage reckless, short term behaviour. The best way to minimise conflicts of interest is to pay decent salaries. The FSA should ensure that bonuses paid to directors, senior management and key persons factor in: financial indicators (profits etc), impact on employees, and the impact on consumers (8). Moreover, regulators must get tougher and more transparent on enforcement. The FSA should be given the power to fine firms up to 30% of their annual turnover for breaches (9).

4. IMPROVED INSTITUTIONAL GOVERNANCE AND LONG TERM INVESTORS

Banks should be requested to introduce public interest representatives to their main boards. The FSA must ensure that non-executive directors (NEDs) play a more active role in managing risk and are independent and capable of providing objective oversight of operations. Pension scheme governance should be enhanced by increasing the number of scheme member representatives on trustee boards. An independent review should be launched to investigate the role and objectivity of influential intermediaries such as pension fund consultants, investment managers, and actuaries in the crisis. Statutory disclosure of corporate governance information is needed to ensure trustees and citizen-owners can exercise responsible influence over financial markets. Information disclosure in the public interest must be given precedence over commercial interests to ensure transparency and accountability.

5. REFORMING THE BANKS

Radical reform of the banking sector is needed with the creation of: i) common good, utility banks with public interest objectives (10), ii) investment banks and iii) a strategic investment bank (11). UKFI (12) should be given clear, strategic objectives to prepare banks for this separation. To promote financial inclusion: banking should be a universal service obligation (13); Government should introduce a UK version of the USA Community Reinvestment Act; and the Government should provide development funding to create Social Investment Bonds to channel sustainable capital into community based lenders.

6) For example, tax havens, offshore centres, off-balance sheet investments, hedge funds and private equity

7) Such such as commission driven sales and bonuses

8) For example, quality of sales, adverse regulatory decisions, and misselling cases

9) Similar to the powers available to competition authorities

10) Including maintaining access to banking services and lending to industry

11) To provide longer term, risk or venture capital

12) UK Financial Investments which manages the stake the public has in the banks

13) The European Commission is consulting on how best to ensure that all EU citizens have access to a basic bank account by a certain date

The full report can be downloaded from the Unite website – www.unitetheunion.com

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