The **Financial Inclusion Centre**

REFORMING THE FINANCIAL SYSTEM

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Commissioned by Unite the union

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www.inclusioncentre.org.uk

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Foreword from Derek Simpson,

Unite Joint General Secretary

Unite is the union which represents employees in the financial services industry. The financial turmoil which has gripped the world has brought insecurity to staff in the UK and damaged the reputation of this vital sector of the economy.

We have commissioned this research in recognition that this is the biggest crisis facing the financial services industry in modern times. There must be an urgent regulatory overhaul in order to rebuild a successful and responsible sector.

Unite has welcomed the action by the Government to inject capital into the markets. The union is demanding that this is financial support is tied to clear commitments to secure vital jobs and make the industry more transparent and accountable. The current situation provides an opportunity to re-build a financial system that supports a long-terms outlook and is consistent with democratic aims, financial stability and social justice.

As the current financial crisis began to take hold in October 2008 Unite launched a 'Social Contract' for the financial services sector. This calls on the Government and finance companies to adhere to.

THE UNITE SOCIAL CONTRACT STATES:

1. Recognition of Unite as a key stakeholder in the future of the financial services industry.
2. To ensure the employment security of employees in the finance sector.
3. To protect and improve the terms and conditions of employees, including pension arrangements.
4. End the remuneration packages of senior executives which reward short-termism and irresponsible risk taking.
5. Overhaul of the regulatory structures of the financial services sector to include trade union involvement in order to enhance the accountability of finance institutions.

www.unitetheunion.com/socialcontract

I welcome this report as a discussion document for reform of the financial services industry in order to deal with the key challenges the sector is facing. There can be no doubt that staff in the industry and consumers are central to the overcoming this crisis.

Derek Simpson, Unite Joint General Secretary

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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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

INTRODUCTION AND BACKGROUND

The recent financial crisis has shown that in a modern, globalised financial system we need to strengthen our financial system and institutions so they are better able to withstand future shocks. The case for fundamental reform of the financial system is overwhelming. We now need to begin the long process of understanding what did go wrong and create a diverse, sustainable financial system that meets the needs of all in society. Moreover, that financial system must be made accountable to wider social objectives.

Banks must be held to account for their role as primary agents in almost wrecking the financial system (under proper conditions banks should be the agents of sustainable wealth creation – this is not an attack on banking). Our regulatory system failed to regulate the banks' behaviour effectively and ensured that long term investors did not, or could not, exercise due diligence. The genesis of the crisis can be found in the 'Big Bang' of 1986 when the banking system was 'liberalised'. The Financial Services Authority has operated a regime where directors were given far too much discretion to interpret rules on prudent lending and corporate behaviour.

To be fair to the FSA, regulation is driven to a degree by international agreements determining how banks manage risks. Nor is it hard to imagine the outraged squeals from the financial services industry about 'nanny-state' interventions if the Government had tried to micro-manage the banks or prevent consumers getting onto or moving up the property ladder.

We as citizen-owners of financial institutions through our pension funds, investments, savings, and strategic stakes in the rescued banks can play a more influential role in holding the sector to account. Banking is as important to society as utilities like gas, electricity and water. Banks must be restructured and regulated so the system meets the needs of the economy and consumers (including the financially excluded).

But we cannot hold banks to account without the necessary mechanisms. There is a serious democratic deficit in the financial system. There are very few public interest representatives (1) at the heart of the system to represent the interests of society or challenge market orthodoxy. Moreover, the protection given to banks by financial regulators means that our Freedom of Information Act is largely toothless when it comes to exposing corporate malpractice.

We cannot leave the running of the financial system to the financial establishment – this is just rearranging the deck hands, if not the deck chairs, on the Titanic. The public interest needs to be elevated above narrow commercial interests. Collectively, we must become better and more demanding stewards of the financial system.

This report was researched and written by Mick Mc Ateer and Delroy Corinaldi of The Financial Inclusion Centre. We would welcome any comments or views on these preliminary proposals.

March 2009

1. A NEW REGULATORY ARCHITECTURE

In this section, we argue that if regulation is to be effective a new regulatory architecture is needed to coordinate interventions. In order to promote financial stability and manage systemic risk the system of macro-prudential and micro-prudential regulation needs to dovetail. As we now know from experience, in modern international capital markets, what starts off as a problem with an individual financial institution, can very quickly be transformed into a systemic crisis.

The previous system of financial system regulation did not recognise that the total risk in the financial system was greater than the sum of the specific risks associated with individual financial institutions. The regulatory system did not pick up how vulnerable the system was to a withdrawal of wholesale funding. A crisis of liquidity in the system turned into a solvency crisis for individual firms.

We argue that it is legitimate for micro-prudential regulatory standards to be agreed, and in effect monitored and enforced, at international level even if the precise regulations and rules are implemented via EU and UK institutions (see above). But, we do not believe that is legitimate for macro-regulation to follow the same framework. Macro-economic decisions must remain the preserve of national governments and elected representatives acting on behalf of their citizens.

REGULATORY FUNCTIONS

Before going onto to outline our proposals for reforming the financial system it is useful to describe the range of different activities that are regulated to ensure the financial markets work in the interests of consumers and society.

These include matters related to financial markets such as:

- exchange functions ie. the operation of stock exchanges and markets;
- wholesale market activities such as investment banking;
- financial system stability/ macro-prudential regulation/ systemic risks;
- legal aspects – the basic legal and authorisation of market participants;
- micro-regulation – the prudential supervision of individual firms;
- retail/ conduct of business activities – this covers how firms treat consumers, efficiency of distribution, marketing and promotion, quality of advice and information provided to consumers, the behaviour of firms and intermediaries/ advisers;
- competition matters;
- the role of information intermediaries – this includes the behaviour of the various intermediaries quality of information used by the market and various intermediaries that produce information (such as auditors, actuaries, and credit rating agencies);
- redress – including consumers right to complain and obtain redress if things go wrong;
- protection schemes – designed to ensure consumers' losses are mininised in the event of a firm failing.

(1) Such as dedicated consumer representatives or employee representatives

However, financial markets are central to the functioning of society. It cannot be assumed that if policymakers regulate (or the market itself regulates) the above activities effectively, the wider needs of society will automatically be met effectively.

Therefore, policymakers must also factor in wider economic and social policy considerations such as:

- maintaining access to financial services (possibly through regulating banks as utilities, universal service obligations, and a community reinvestment act);
- maintaining lending to key economic sectors; and
- wider economic and monetary policy.

So, any reforms to the regulatory architecture must take into account those different regulatory activities and ensure that those activities are coordinated and implemented at international, EU and UK level.

MACRO-PRUDENTIAL/ SYSTEMIC REGULATION

INTERNATIONAL LEVEL

International financial institutions will need to play a more effective role in maintaining stability in the global financial system, preventing systemic crises recurring in future and coordinating responses to crises that happen. Greater cooperation on financial stability, crisis prevention, crisis monitoring, and crisis resolution is needed. A new International Financial Stability Agency (IFSA) should be established based on the existing Financial Stability Forum (FSF) with overall objectives to:

- promote financial stability; and
- improve the monitoring, prevention, management, and resolution of systemic financial crises.

Agency Governance

This governing board of the agency should include lead representatives from the major global authorities and agencies such as Bank of International Settlements, IMF, and OECD, ministries of finance, central banks, and public interest representatives. To promote good governance a minimum number of seats on governing board should be reserved for public interest representatives. The board should also reflect the changing nature of the global economy with a minimum number of seats reserved for developing economies. The agency should be funded directly by national governments.

Activities

The key activities of the IFSA should be to:

- establish improved systems for monitoring the global financial system;
- identification of systemic risks;
- issue risk warnings and guidance to regional and national macro-prudential regulators;
- coordinate relationships between the relevant regional and national macro-prudential regulators;
- coordinate working relationships with macro-prudential and micro-prudential regulators;
- coordinate responses to financial crisis.

We do not envisage that this new agency should have executive authority to dictate to national authorities (such as central banks or ministries of finance) which policy interventions should be used to deal with financial crises – for example, quantitative easing, or recapitalisation programmes. The reason for this is that these macro-prudential interventions involve the use of public money. These decisions should be left to sovereign state authorities.

EU LEVEL

Much of the regulation that is supposed to protect UK citizens emanates from EU institutions. These institutions also need to be reformed so that they play a role in maintaining stability, crisis management, and regulating the behaviour of individual financial institutions in the EU. To do this, we take the view that there will have to be a de facto EU single regulator for the major financial services sectors – banking, insurance and securities and investment. A new European Financial Stability Agency (EFSA) should also be established under the auspices of the European Central Bank (ECB). The overall objectives of EFSA should be to:

- promote financial stability at EU level; and
- improve the monitoring, prevention, management, and resolution of systemic financial crises at EU level.

Agency Governance

The governing board of the agency should include lead representatives from the major EU authorities and agencies such as ministries of finance, central banks, and European Supervisory Authorities such as CEBS, CEIOPS, and CESR, and public interest representatives. To promote good governance a minimum number of seats on governing board should be reserved for public interest representatives. The board should also reflect the changing nature of the EU economy with a minimum number of seats reserved for emerging EU economies.

Activities

The key activities of the EFSA should be to:

- establish and coordinate improved systems for monitoring the financial system in the EU;
- identification of systemic risks;
- issue risk warnings and guidance to national macro-prudential regulators;

- coordinate relationships between the relevant national macro-prudential regulators;
- coordinate working relationships with macro-prudential and micro-prudential regulators within the EU;
- coordinate responses to financial crisis at EU level.

As with the IFSA, we do not envisage that this new agency should have executive authority to dictate to European national authorities (such as central banks or ministries of finance) which policy interventions should be used to deal with financial crises – for example, quantitative easing, or recapitalisation programmes.

UK NATIONAL LEVEL

Similarly, the key regulatory institutions in the UK, the Bank of England, the FSA, and the OFT need to be reformed. Moreover, the relationships between HMT, BoE and FSA needs to be clarified and redrawn to ensure the regulatory system is fit-for-purpose and efficient. We also propose a new regulatory architecture for promoting financial stability and managing systemic risk at UK level. We go into some detail on this so we have devoted a separate section on UK architecture.

MICRO-PRUDENTIAL/ FINANCIAL INSTITUTION REGULATION

Improving the way systemic risks in the global financial system are managed is critical. However, radical reform to the way individual financial institutions are regulated and supervised is equally important to restore confidence, protect consumers and promote financial stability.

Macro and micro-prudential regulation is closely linked – after all the international financial system is made up of individual financial markets, financial institutions and consumers. Financial markets are notoriously susceptible to herd behaviour and contagion and the reckless behaviour of a handful of irresponsible financial institutions can trigger global, systemic crises. Moreover, macro-prudential regulation cannot exist as a system of hypothetical aims. It needs to be put into effect through rules that control the behaviour of financial institutions.

The work of macro-prudential and micro-prudential regulators and supervisors needs to be coordinated to be effective. These regulators need to work closely together. Given the need for coordination and cooperation there is a strong case for combining the macro and micro-prudential functions within the same organisation.

However, we believe there is a stronger case for separating macro and micro regulatory institutions. This is primarily in the interests of clarity and efficiency. At the risk of being pedantic, it is worth explaining the distinction between regulation and supervision. Regulation is the setting of standards of behaviour and rules. Supervision is the monitoring and enforcement of those rules by regulators. The architecture we propose is based on a system where regulatory standards are set at international/ EU level to promote consistency and prevent regulatory arbitrage, while supervision and enforcement is undertaken by national regulatory authorities.

INTERNATIONAL LEVEL

A new International Financial Regulation Agency (IFRA) should be established to set prudential standards for financial institutions and act as coordinator-regulator for global financial institutions that represent systemic risk to the financial system.

Agency Governance

This governing board of the agency should include lead representatives from the major global authorities and standards settings agencies such as the Basel Committee, IOSCO, IASB and public interest representatives. To promote good governance a minimum number of seats on governing board should be reserved for public interest representatives. This agency should be funded by national governments.

Activities

The key activities of the IFRA should be to:

- coordinate and establish standards of prudential regulation for financial institutions such as banks and insurance companies;
- develop improved systems for monitoring global financial institutions;
- identification of systemic risks;
- issue risk warnings and guidance to regional and national micro-prudential regulators;
- coordinate relationships between the relevant regional and national micro-prudential regulators;
- coordinate working relationships with macro-prudential and micro-prudential regulators;
- coordinate responses to financial crisis with IFSA.

EU LEVEL

Much of the regulation that is supposed to protect UK citizens emanates from EU institutions. These institutions also need to be reformed so that they play a role in regulating the behaviour of individual financial institutions in the EU including the UK. To do this, we take the view that there will have to be a de facto EU single regulator for the major financial services sectors – banking, insurance and securities and investment, accounting standards and credit rating agencies.

A new European Financial Regulatory Authority (EFRA) should also be established to set prudential standards for EU financial institutions, act as coordinator-supervisor for larger EU wide financial institutions that represent systemic risk to the financial system of the EU, and set standards for valuing financial assets. For practical purposes, EFRA should be comprised of specialised authorities responsible for regulating specific types of financial institutions ie. a banking, insurance companies and pension funds, asset management firms and securities firms, and credit rating agencies. These specialised authorities should be created

from the existing 'level 3' committees – CEBS, CEIOPS, and CESR. In the interim, these level 3 committees should be given more powers and authority to set robust, harmonised, minimum standards for prudential regulation of EU financial institutions.

Authority Governance

The governing board of EFRA should include lead representatives from the major EU supervisory authorities such as CEBS, CEIOPS, and CESR, and public interest representatives. To promote good governance a minimum number of seats on governing board should be reserved for public interest representatives. The board should also reflect the changing nature of the EU economy with a minimum number of seats reserved for emerging EU economies.

Activities

The key activities of EFRA should be to:

- coordinate and establish standards of prudential regulation for all financial institutions such as banks, insurance companies, and hedge funds, and financial instruments such as securitised investment vehicles;
- develop improved systems for monitoring EU financial institutions;
- identification of systemic risks caused by behaviour of financial institutions;
- issue risk warnings and guidance to national micro-prudential supervisors;
- coordinate relationships between the relevant national micro-prudential supervisors;
- coordinate working relationships with macro-prudential and micro-prudential regulators;
- coordinate responses to financial crisis with EFSA.

EFRA should have executive authority to dictate to EU supervisory authorities the appropriate regulations and standards. The day-to-day monitoring and supervision should be the responsibility of national supervisory authorities.

REFORMING UK REGULATION

If the UK's system of regulation is to become fit-for-purpose and meet the needs of society, the regulatory architecture needs to be radically reformed. Moreover, the roles and responsibilities of the key regulatory authorities - HMT, FSA, Bank of England, Financial Reporting Council (FRC), Office of Fair Trading and competition authorities – need to be revised and clarified. As we outline above, there is a wide range of activities that need to be undertaken if markets are to be regulated. Clearly, there are a number of ways of dividing up responsibility for these activities between the various regulatory authorities (or indeed new institutions created).

However, our high level view is the UK regulatory structure must be simplified and streamlined.

The key elements of our proposals are:

FSA

The FSA should become a dedicated consumer protection agency with responsibility for:

i) prudential supervision (including the supervision of information providers such as credit rating agencies);

ii) regulation of all retail financial services activities (including those financial services currently covered by the OFT); and

iii) regulation of public policy objectives (for example, access and exclusion issues).

BANK OF ENGLAND

The main responsibility for regulating exchanges, the Listings Regime and wholesale market activities, and maintaining financial stability should reside with the Bank of England.

OFT AND COMPETITION COMMISSION

Competition issues should remain the responsibility of OFT and Competition Commission.

FINANCIAL REPORTING COUNCIL (FRC)

The FRC would retain responsibility for overseeing regulation of auditors, actuaries, and accountants.

THE PENSIONS REGULATOR

The Pensions Regulator would retain responsibility for regulating employers' pension schemes.

RELATIONSHIPS BETWEEN CENTRAL BANKERS AND REGULATORS

If we are to create more effective system for maintaining financial stability and macro-prudential regulation central bankers and regulators need to be given the appropriate mechanisms for intervention (a range of mechanisms are set out below).

However, if these mechanisms are to be used to best effect, greater cooperation and a more effective relationship between central bankers and prudential regulators/ supervisors is needed at international, EU and UK level. Clearly, it is to be hoped that central bankers and regulators would recognise the need to maintain financial stability and agree on the appropriate measures.

But, it would need to be made clear that financial stability and macro-prudential regulation should take precedence over micro-prudential regulation at UK national level. This should be done through a new Memorandum of Understanding between HMT, the Bank of England and FSA which sets out in clear terms operational responsibilities.

2. GOVERNANCE OF REGULATORS AND THE DEMOCRATIC DEFICIT

An issue that seems to have been largely overlooked in debate about the causes of the financial crisis is the weak governance and accountability of regulatory authorities and the absence of meaningful public interest representation at decision making level within those authorities.

Public interest representatives have been warning for some time that the approach to financial regulation followed by regulators was not sufficiently robust, consistent or comprehensive to cope with the challenges presented by modern, international financial markets.

If the various institutions that comprise the regulatory system are to be effective at regulating powerful financial markets then they in turn must be reformed. The effectiveness and accountability of the regulatory system has been undermined by the lack of direct public interest representation at policy making and decision making level.

The relationship between regulators and regulated has become dysfunctional. Financial markets have fallen victim to the herd-instinct compounded by a sense of arrogance in the infallibility of markets and financial market operators. But the regulators who were meant to be regulating these markets have also fallen victim to 'group-think' believing that the role of regulators was to create the conditions for markets to operate, and then take a step back to allow the informed 'self-interest' of markets to police itself .

There have been far too few independent public representatives at decision making level willing and able to challenge the market or regulatory orthodoxy that markets know best. The dominance of the financial services industry within regulatory power structures and sheer influence of the industry on regulators is striking and cannot be allowed to continue.

The overwhelming majority of the members of the FSA's previous and current boards are from the financial services industry. It doesn't end there. UK Financial Investments (UKFI) is the body set up to manage the stake taxpayers have in the rescued banks. But, the appointments of Chairman-designate and the deputy Chairman went to members of the financial establishment while all four newly appointed non-executive directors are either bankers or investment managers. No provision seems to have been made for independent public interest representation. To cap it all, the Chair of the banking review panel set up to investigate corporate governance in the banks, including bonuses, is a banker.

These organisations need to utilise the skills of financial experts. But, as a matter of principle, there is simply no justification for regulatory institutions not having meaningful public interest representation at the highest decision making level. Policymaking would improve if it was subject to direct scrutiny by public interest representatives and allow the regulators to avoid the perceived and real risk of regulatory capture by powerful industry lobbies.

Public interest groups are comparatively powerless when compared to the financial services industry lobbies. Public interest representatives have comparatively few financial resources compared to powerful global financial institutions whether acting unilaterally or through trade associations to undertake research, lobby policymakers and opinion formers.

Indeed the democratic deficit is striking at all levels. As our analysis, below, shows there are far too few independent, well-resourced public interest representatives at the heart of the regulatory system whether at international, European Union or UK national level.

As a result, it is only fair to conclude that at decision making level, the public interest is not properly represented and the influence of public interest representatives severely diluted.

Therefore, it is very disappointing that the mistakes of the past have been repeated at UK level with the establishment of UKFI (2) and at EU level with the creation of the De Larosiere Group (3) (see below for details). This has got to change. The lack of public interest representation at the highest level smacks of arrogance on the part of policymakers and regulators. But this is not mere tokenism.

As a matter of principle, there is simply no justification for financial regulators and policy makers not having meaningful user representation embedded at the highest decision making level given the importance of financial markets to society.

Moreover, the quality of decision making by regulators and policymakers would improve if it was subject to direct scrutiny by user representatives who would have the independence and objectivity to challenge market and regulatory orthodoxy (group-think). Furthermore, a commitment to user representation promotes confidence in the system and allows policymakers and regulators to avoid the perceived and real risk of regulatory capture by powerful industry lobbies.

It is important to correct the damaging impression that representatives from the same type of institutions that share most of the blame for the financial crisis (regulators and financial institutions) are now being given the responsibility for developing policies to prevent a crisis recurring. This does not promote consumer confidence in the policymaking process.

UK REGULATORY GOVERNANCE

There is a clear, and striking democratic deficit at the heart of the UK regulatory system which needs to be addressed as a matter of priority.

THE FSA

The Financial Services Consumer Panel does an admirable job but is more than offset by the existence of two industry/ practitioner panels. Moreover, the Panel has nowhere near sufficient resources to counter the influence of powerful industry lobbies.

More fundamentally, there is little public interest representation to speak of at the highest decision-making levels within the FSA. In its history,

(2) UK Financial Investments Limited

(3) The De Larosiere Group was set up by President Barrosso to analyse the causes of the financial crisis and make recommendations on how to prevent a crisis recurring

only a very small minority of the board members of the FSA could be considered civil society/ public interest representatives. The clear majority of the current board members are from the financial services industry. The FSA's current board has 13 members, 11 of which are either currently involved with the industry or have an industry background.

Moreover, we are of the view that this would allow FSA to avoid the perceived and real risk of regulatory capture by powerful industry lobbies.

BANK OF ENGLAND

The main governing body of the Bank of England is the Court of Directors. The Court's responsibilities includes determining the Bank's objectives and strategy, ensuring the effective discharge of the Bank's functions and ensuring the most efficient use of the Bank's resources.

However, of the current 13 non-executive directors, only one could be considered to be a public interest representative (4). Eight of the directors are from industry (including four from the financial services industry). Four could be considered as 'independents'. This represents a clear deficit in the representation of public interest organisations.

Transparency and accountability

Moreover, the lack of real transparency in the financial system further and seriously undermines the lack of public interest representation in the system. The effectiveness of the UK's Freedom of Information Act is rendered more or less useless by the protection given to commercial interests by UK financial regulation. Therefore, the Government should as a priority review the application of the FOI Act to FSMA 2000.

UK RECOMMENDATIONS

1: At the first opportunity, the Government should ensure that at least one-third of the non-executive directors of the FSA should be dedicated public-interest representatives. This long term aim should be for half of the FSA board to be public interest representatives. The Court of the Bank of England should also be made up of at least one third public interest representatives. Public interest representative in this case should be defined as consumer representatives, trades union representatives, and other representatives from the third sector (for example, charities or advice agencies). No more than one-third of the board members of the FSA or Court should have a financial services industry background. We define the individual as being from the financial services industry if i) they are currently working in the industry or ii) have spent a significant amount of their career working in the industry – in this case, at least 50% of their career. The remainder of the board positions of FSA and Court may be filled by traditional 'independent' non-executives such as academics.

2: Public interest representatives on the governing boards should have access to dedicated, independent technical expertise and sufficient resources to support their role with independent secretariat (in the case of the FSA potentially sharing with the FS consumer panel – see below).

3: With regards to appointments to main boards, public interest organisations should have the right to submit candidates to the Government to fill the public interest representative positions on the main board. Moreover, any appointments panel overseeing the appointment of individuals to the main board of regulators should contain representatives from public interest organisations.

4: The FS consumer panel and Court of Bank of England should be consulted at the earliest possible stage on changes of policy and prioritisation of activities. The panel and Court should have access to dedicated, independent technical expertise and sufficient resources to support their role, with own research capacity including financial resources to undertake independent research and dedicated research staff.

5: FSA and Bank of England should be required to attend public hearings each year following publication of their annual reports. They should be required to present their annual reports and answer questions put to them by dedicated public interest committees conducting the hearings. The hearings should be organised by respective public interest representatives who should ensure that the public interest committees reflect the public interest.

6: Governments and regulators should adopt a new, transparent approach to disclosing information relating to corporate behaviour and regulator's enforcement decisions. Regulators should introduce a new rule that requires financial firms to publish key consumer information that might affect a consumer's decision to enter or continue a relationship with the firm. The categories of information should include: consumer complaints data; decisions by financial ombudsman schemes; policies and procedures; and details of regulatory breaches along with summaries of action taken to address problems. Firms should also be required to produce compliance reports twice a year providing a detailed assessment of performance against regulatory requirements.

7: European Commission, national governments and regulators should review any legislation that prevents information being published in the public interest. The default position should be that the public interest and consumer interest should take precedence over narrow commercial interests. The presumption should be that all information should be disclosed unless it is clearly demonstrated that disclosing information is not in the public interest (5). Holding regulators and firms to account for performance depends on user/ consumer representatives having access to information.

EUROPEAN UNION LEVEL

We also looked at the structure and representation of the main regulatory institutions at EU level. We concentrated on the important

(5) For example, if it was clear that disclosure would jeopardise enforcement proceedings, or if disclosure of trading positions would leave firms vulnerable to attacks by rivals

'level 3' committees – CEBS (6), CEIOPS (7), and CESR (8). These level 3 committees are so called because of the position these committees occupy within the 'Lamfalussy process'. These level 3 committees are extremely important in the policymaking process at EU level. Moreover, these committees are likely to be transformed into more powerful executive regulatory authorities under proposals announced by the European Commission (9).

Each of the level 3 committees have consultative panels as part of their efforts to fulfil the transparency requirements of the Lamfalussy process. Committees are required to consult extensively and openly with market practitioners, providers, consumers and end-users.

These consultative panels are composed of 'independent' high level persons appointed on a personal basis. In theory, they are not supposed to represent national positions or sectoral interests.

But our analysis of these consultative panels shows just how underrepresented public interest/ civil societies are at EU level as well.

CEBS: The CEBS Consultative Panel has 21 members. According to the current list on its website, only three members have a user/ consumer representative background (10). CEBS currently has six expert groups. There appear to be public interest/ civil society representatives on these groups.

CESR: the CESR Consultative Panel has 17 members. According to the current list on its website, only one member has a user/ consumer representative background (the status of four members is not specified). CEBS has 16 expert and operational groups. There appear to be no public interest/ civil society representatives on these groups.

CEIOPS: the CEIOPS Consultative Panel has 17 members. Only one member has a public interest/ civil society (11) background. CEIOPS has 11 working groups. It is not clear who the members of these groups are. However, we are not aware of any consumer/ user representatives being members of these groups.

Overall, we have to conclude that industry lobbies are over-represented at EU level. This must give the industry undue influence during the process of formulating, developing and implementing policy and comprehensive, new measures are needed to improve public interest representation at EU level.

Therefore, it is very disappointing that the mistakes of the past have been repeated with the creation of the De Larosiere Group. There has been no direct user representation on the Group. We should make it absolutely clear that we are not criticising the individuals on the Group – they are all eminent, respected members of the financial establishment. However, that is the very point – they are members of the 'establishment' and none could be considered dedicated user representatives. All have a background as financial regulators or have held senior positions with financial institutions.

We noted that the intention was that the Group would conduct hearings and organise a consultation as appropriate. However, it is clear from the report that user-representation in the policymaking process was not even considered important enough for inclusion in the Group's considerations. Indeed, not only were public interest representatives excluded from the Group, the Group restricted its evidence taking to *'personalities and representatives of European financial services associations and international institutions'* (12) including trade associations such as CEA, AMICE,EBF, ESBG, ICMA, EFAMA, FOA, and representatives of large insurance companies (AXA, Munich Re, AEGON, and AVIVA plc) .

It is important to correct the damaging impression that representatives from the same type of institutions that share most of the blame for the financial crisis (regulators and financial institutions) are now being given the responsibility for developing policies to prevent a crisis recurring. This does not promote consumer confidence in the policymaking process. It is now imperative that mechanisms are instigated to ensure that interests of users are represented in the future during the implementation of the Group's recommendations.

RECOMMENDATIONS

This second set of recommendations is intended to improve the functioning and accountability of important EU regulatory institutions – primarily the important level 3 committees (CEBS, CEIOPS, and CESR).

1: Each of the level 3 committees should ensure that at least one-third of the consultative panels are dedicated public interest representatives.

2: Each of the committees should ensure that the consultative panels have access to additional resources to support the work of consultative panels – including budgets for travel and other expenses to allow members to attend panel meetings.

3: Each committee should establish a public interest expert group. The role of the expert group should be to: provide insight to level 3 committees on the impact of consultations and initiatives on citizens; ensure the Lamfalussy process takes the public interest into account; ensure any consultation process factors in the public interest.

4: Each committee should appoint a public interest coordinator. The role of the coordinator should be to support the work of the public interest expert group and coordinate relationships with public interest/ civil society organisations.

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(6) Committee of European Banking Supervisors

(7) Committee of European Insurance and Occupational Pension Supervisors

(8) Committee of European Securities Regulators

(9) See European Commission, Communication for the Spring European Council, Driving European Recovery, COM (2009) 114/ Provisional version

(10) Including one of the authors of this report

(11) One of the authors of this report

(12) See Annex II: Meetings of the Group and Hearings in 2008-2009

3. A NEW APPROACH TO REGULATION

The existing regulatory architecture meant the financial system was structurally weak which left it vulnerable to the perfect storm of events that hit the markets. The proposed regulatory reforms set out here are designed to:

- promote financial stability;
- allow policymakers and regulators to better identify systemic risks, prevent crises from developing and manage crises if they do emerge;
- promote confidence in the financial system;
- create a more coherent, consistent, targeted and proportionate regulatory system at UK and international level built around robust minimum standards;
- introduce better supervision and risk management of individual firms;
- better align the interests of all the parties in the financial system;
- improve governance, accountability and transparency in the financial system;
- improve the efficiency of financial markets.

REGULATORY APPROACH

Public interest representatives have been critical in the past of the close relationship between regulators and regulated (see regulatory governance). Moreover, UK regulators:

- have been too timid and deferential to senior management of financial institutions been unwilling to intervene robustly in the running of firms;
- abdicated too much responsibility to firms for interpreting regulations;
- have been unwilling to challenge market and regulatory orthodoxy (wearing rose-tainted spectacles when it comes to a belief that market forces and self-interest of market participants will lead to optimum outcomes for consumers and society).

The principles/ risk based regulatory approach is meant to be in contrast to previous systems of regulation which is more prescriptive, rule-based, and involves close monitoring and hands-on supervision of firms. Principles based regulation is meant to be more flexible and better suited to dealing with fast moving and innovative financial markets.

But principles based regulation doesn't work without effective governance and accountability mechanisms to manage the conflicts of interests inherent in the financial system, and without robust enforcement and penalties for breaches of regulations. Moreover, with regards to prudential regulation, concerns were raised that firms were allowed to use far too much discretion over the use of internal risk models and valuing off-balance sheet assets. This has contributed to the opacity and lack of trust in the financial system.

SCOPE OF REGULATION

If regulation is to be effective, it must apply consistently and coherently to the entire financial system regardless of jurisdiction or the type of financial institution involved.

We cannot ignore regulatory failure at the retail level. The recent crisis was not caused solely by a failure of prudential regulation. An unsustainable credit bubble was allowed to develop partly driven by reckless lending by lenders to borrowers. If the risk of a future crisis is to be reduced, the conduct of business and market practices of lenders also needs to be regulated more effectively.

RISK MANAGEMENT

Below, we set out a series of critical measures for managing risk in the financial system.

REGULATING ASSET PRICES

Central banks and regulators should be given a policy objective to actively consider asset price inflation (not just consumer price inflation) as part of their remit, and if necessary be required to take action along with financial regulators to moderate asset price growth by restraining lending, or conversely to take action to tackle asset price deflation. There are a number of possible interventions they could deploy through the Basel II framework – probably through the pillar II process (13).

CONTRA-CYCLICAL CAPITAL REQUIREMENTS

If indicators such as growth in mortgage lending and house prices suggested that an asset price bubble was emerging in the property market, regulators could require banks to increase their minimum capital requirements. Conversely, contra-cyclical regulation could be used to stimulate lending during periods of prolonged lending droughts or asset price deflation. It is critical that when the FSA is satisfied that lenders' balance sheets are restored to prudent levels, it begins to apply the contra-cyclical approach.

RISK RATINGS

Regulators could, as an alternative to contra-cyclical capital requirements, attach a higher risk rating to certain asset classes – in this case mortgages and unsecured loans. This could have the dual benefit of improving the micro-regulation of individual firms as well as the macro-regulation of the mortgage market as it would provide an in-built restraint on mortgage lending.

(13) Pillar 1 of Basel 2 consists of rules which require banks to hold minimum capital to protect against credit, operational and market risks. The intention of Pillar 2 is to require banks to take into account all the additional risks the bank is exposed to when calculating capital requirements.

LIQUIDITY RISK MANAGEMENT

One the reasons for the failure of regulators to control liquidity risk is the principles based regulatory approach that relies too much on lenders' internal risk models or provides too much discretion on the definition of high-quality, liquid assets to be used as collateral. Regulators will have to move away from this reliance on qualitative, principles based regulation to more detailed standards setting on liquidity risk management.

OTHER RISK MANAGEMENT MEASURES

A number of other measures may be needed to ensure that lenders and investors (where wholesale funding is involved) recognise the quality of loans made to consumers. Lenders need to improve the way data is shared so that they can understand better the ability of borrowers to repay mortgage debt.

However, other innovative approaches could be considered including requiring banks to take an equity stake in structured investment vehicles. This would align better the interests of borrowers, banks and investors as banks would have a real interest in ensuring loan portfolios are of good quality.

MONITORING AND ENFORCEMENT OF PRINCIPLES-BASED REGULATION

Consumer advocates have constantly warned about the risk of 'regulatory arbitrage' where market participants attempt to shift their activities to jurisdictions or financial institutions that are less regulated and transparent, or to less well regulated or transparent financial mechanisms such as off-balance sheet vehicles, securitised investment vehicles (SIVs). Therefore, the regulatory framework will need to ensure that it does not encourage regulatory arbitrage and policymakers need to adopt consistent, robust regulation.

TAX HAVENS AND OFFSHORE FINANCIAL CENTRES

We advocate a clampdown on tax havens and offshore financial centres. To begin with more transparency is needed. We recommend that a suitable international financial institution (eg. the OECD) draw up a list of jurisdictions that refuse to cooperate with the regulatory or tax authorities of other jurisdictions. These jurisdictions should be risk rated according to transparency and regulatory protection/ legal security. Furthermore, banks, insurance companies and pension funds, and asset management companies should then be required to disclose to what extent they use these jurisdictions. This should help institutional investors such as pension funds and consumers understand the legal and regulatory risks their savings and assets are exposed to and improve due diligence and corporate governance standards. Furthermore, financial institutions that continue to use these risk rated jurisdictions, should be required to hold higher levels of risk capital to offset the risk. This should reduce the risk of regulatory arbitrage (14). Ultimately, international agreements will be needed to close down tax and offshore centres that are not properly supervised.

COMPLEX FINANCIAL PRODUCTS

Innovations such as securitisation started off as a genuine attempt to diversify risk and reduce mortgage funding costs to increase access to mortgage finance for excluded consumers. But this was corrupted by the market and used to conceal risk. Regulators will have to regulate complex financial products more effectively and apply more detailed standards to the way these instruments are consolidated onto the balance sheets of financial institutions.

REGULATING NON-BANK FINANCIAL INSTITUTIONS

The fragmented approach to regulation (which regulates institutions according to their legal and corporate structure rather than their function) has allowed non-bank financial institutions to behave like banks without being regulated as banks. A parallel banking system has developed. The approach to regulation needs to be more consistent and coherent with financial institutions regulated according to the functions they undertake and the risk they pose to consumers and the financial system. The same approach to consistency should apply to the regulation of financial instruments and asset classes.

IMPROVING GOVERNANCE AND MANAGEMENT OF CONFLICTS OF INTEREST

The undue risk taking and irresponsible lending can be traced back to the various conflicts of interest that exist along the financial services supply chain:

- commission and aggressive remuneration practices mean that sales staff and intermediaries face a conflict between making a sale and offering borrowers appropriate advice. Ordinary employees are as much a victim of the practices imposed on them as consumers;
- aggressive bonus payments which reward key persons for taking excessive risks – this provides incentives for employees to take undue risks but also conceal exposures or loss making positions;
- conflicts of interest between non-executive directors and executive directors/ senior management;
- financial conflicts between lenders, investors and supposedly objective third parties such as credit rating agencies.

A key regulatory objective should be identifying and managing these conflicts of interest more effectively.

(14) These measures should be seen as complementary to, not a substitute for, much needed efforts to clean up tax havens and prevent corporations from avoiding tax – however, this issue is outside the remit of this report.

THE ROLE OF REMUNERATION STRUCTURES IN RISK MANAGEMENT

One of the key conflicts of interest arises from the structure of remuneration packages that incentivise market practictioners to take undue risks. This applies to:

- the use of aggressive bonus structures that encourage short termism and concealment of risk in the wholesale markets and
- existence of commission bias in the retail mortgage markets which forces sales staff and other financial intermediaries to meet aggressive lending targets.

If the interests of consumers, shareholders and market practitioners are to be aligned in the market then robust regulatory interventions will be needed to constrain the effects of these remuneration structures at wholesale, institutional and retail level.

Most attention, perhaps not surprisingly, has focused on the impact of the behaviour of wholesale market practictioners such as traders and investment bankers on shareholders, the financial system, and wider economy.

There are a number of options for promoting sustainable, long term behaviour:

- explicit caps on salaries and bonuses – this may be particularly appropriate for financial institutions in which the taxpayer has a stake;
- deferred bonuses paid based on medium term corporate performance with contractual clawbacks (if undiscovered losses emerge post payment of bonus);
- share option structures – where remuneration over and above basic salary is paid in the form of shares linked to agreed, independently audited, long term performance metrics. Although this option will always encourage excessive focus on short term share price movements and needs to be restricted;
- rebalancing total remuneration packages towards more balanced scorecard approach.

However, if progressive remuneration policies are to be successful then:

- the appropriate metrics used to judge performance need to be adopted
- any remuneration policy should be developed in partnership with trade unions;
- performance needs to be judged by independent, objective people;
- the 'performance' of the appropriate people within firms needs to be assessed; and
- policies must be monitored and enforced to ensure they have the desired effect.

METRICS

Choosing the right metrics against which to benchmark performance is obviously important if responsible, sustainable behaviour is to be encouraged. This also means that the appropriate set of stakeholders needs to be identified.

Again, most attention has focused on financial metrics which reflect shareholder benefits. That is, bonuses and options have been linked to the growth in revenue, profits and share price. The criticism here is that the remuneration policies focused on short term performance metrics which incentivised reckless behaviour, or facilitated poor risk management, and in certain cases actual concealment of losses and risks. This may have benefited shareholders in the short term but ultimately led to shareholder value being damaged.

Therefore, if more responsible behaviour is to be encouraged, performance metrics which measure longer term performance need to be incorporated. The precise period over which to measure performance is a difficult one to judge. Ideally, the performance metric period should encompass business cycles. A business cycle is difficult to pin down but it suggests that performance should be judged over at least a rolling three year period.

However, we would very much take issue with the view that detrimental risk behaviours will be controlled by focusing solely on aligning the interests of directors/ employees and shareholders, and by utilising performance metrics which measure shareholder value.

We must remember that directors have an explicit duty to shareholders. Therefore, any policy which retained the emphasis on shareholder value is unlikely to encourage sustainable behaviours such as treating customers fairly.

If we are to see a proper alignment of interests between shareholders (long term investors), directors, employees, and consumers a more relevant set of performance metrics must be utilised. Performance metrics should incorporate three strands to create a flexible, balanced scorecard to provide a more objective assessment of corporate and individual performance. These strands are:

- conventional longer term financial indicators;
- the impact on employees; and
- impact on consumers – for example, quality of sales recommendations, adverse regulatory decisions, misselling cases (15).

Moreover, responsible, sustainable behaviour is likely to emerge if a more collective system of rewards is encouraged. The concentration of large bonuses in the hands of a number of key employees (the rain makers) distorts behaviour and puts the financial futures and livelihoods of employees in the hands of a powerful few with precious little accountability.

(15) For example, we are aware of one mutual organisation where the remuneration committee has the authority to withhold the directors' bonuses. Not surprisingly the firm has never been on the receiving end of a regulatory enforcement decision

APPLICATION OF METRICS

If these metrics are to be effective, the behaviours of directors, key persons and employees need to be addressed.

The balance scorecard approach outlined above is flexible enough to be tailored to different groups within firms. For example, directors and senior managers should be assessed using the three strands in other words: have they created sustainable value for shareholders; have they treated employees fairly; and have they delivered value for consumers and treated them fairly.

Other key persons – for example, those working in high risk areas/ activities – should be assessed according to impact on the firm and clients/ consumers.

A much neglected group are the 'ordinary' employees in financial institutions – particularly front line sales staff. Aggressive remuneration policies have forced sales staff to chase unsustainable targets – one of the key causes of the consumer detriment and misselling scandals witnessed in the UK retail financial services industry over the past two decades.

We need to drive out remuneration policies that encourage reckless sales or consumers being sold inappropriate products. This can be done by moving away from commission driven sales and paying staff decent basic salaries; using the balanced scorecard approach outlined above; and introducing collective rewards systems where any corporate wide benefits are shared more equally amongst employees.

MONITORING AND ENFORCEMENT

There are various measures that can be used to drive destructive practices out of the financial system and incentivise good behaviour. However, these can be categorised broadly as:

- improved corporate governance and self-regulation – for example, non-executive directors and remuneration committees could be required to play a more active role in identifying and managing risk, and setting policy on remuneration; and
- direct regulatory interventions: the FSA could directly or indirectly regulate remuneration practices either by i) introducing a new rule requiring firms to adopt remuneration policies that minimise risk or ii) requiring firms that retain aggressive remuneration practices to manage the risk by holding higher levels of risk capital.

However, we take the view that a combination of measures will be needed to create the necessary system of deterrents and incentives.

THE ROLE OF AUDITORS

Auditors play a critical role as they are meant to ensure the integrity of information in the public domain. The methodologies for measuring risk, valuing, auditing and disclosing information relating to complex financial instruments must be standardised.

THE ROLE OF CREDIT RATINGS AGENCIES

Similarly, credit rating agencies play a critical role in the financial system intermediating between the various participants in the market. The models, methodologies and processes used by credit rating agencies to rate individual firms and rate complex financial instruments need reforming. However, we would take this a stage further and argue that the governance and relationship between ratings agencies and rated firms needs to be regulated also.

Ultimately, over time we believe this should move to a system where there should be no direct financial relationship between the agencies and the institution being rated – that is, the ratings agency fees should be paid by investors who use that information, not the rated institution. Credit rating agencies should be licensed with a clear separation between assessment and consulting activities.

However, as an interim step measures should be implemented to improve:

- governance by requiring agencies to have independent directors;
- operational transparency by requiring agencies to disclose methodologies; and
- quality of models by requiring agencies to have internal quality control and submit these models to regular external review by peers and/ or oversight bodies.

The necessary reforms cannot be achieved through self-regulation by ratings agencies, and we recommend that ratings agencies should be regulated by the FSA or, as an alternative, the FRC (16) (this would fit well with the FRC's role in 'regulating' auditing, and actuarial standards).

THE ROLE OF HEDGE FUNDS

Hedge funds are now a major presence in the financial system as primary investors in complex financial instruments and as intermediaries in the investment supply chain (attracting investment capital from other investors such as pension funds and mutual fund managers). They have played a significant role in transmitting risk throughout the financial system that may not have been understood properly by investors. Even before the crisis broke, concerns had been raised about hedge funds particularly:

- the lack of disclosure and transparency,
- promotional activities (such as the absence of objective comparative performance data to allow investors to make informed decisions); and
- the methods used to value complex, hard-to-value, illiquid financial assets within hedge fund portfolios – raising doubts about the risk/ reward ratios associated with hedge fund investments.

Major reform of hedge fund regulation (and private equity funds) is long overdue to address the concerns outlined above.

(16) Financial Reporting Council

CONSOLIDATION AND INTEGRITY OF BALANCE SHEET ASSETS

To promote consistency, regulators will have to restrict the discretion available to sponsoring banks and apply more detailed standards to the way off-balance sheet investments are consolidated onto the balance sheets of sponsoring banks.

PRICING AND TRADING TRANSPARENCY

Another factor that has damaged market integrity is the absence of efficient and transparent mechanisms for setting market prices for hard-to-value securitised assets. This has two effects: it undermines the ability of investors to make informed decisions about their investments and undertake due diligence; and it undermines the ability of regulators to assess the solvency of firms. To counter this, policymakers need to ensure that comprehensive and meaningful information about transactions in complex financial instruments be placed in the public domain. Policymakers at international level should enable the creation of clearing houses for information on hard-to-value assets.

ACCOUNTING STANDARDS

Some commentators argue that the use of what is known as 'mark-to-market' or 'fair value' accounting rules that require banks to value assets using current market prices has contributed to the banking crisis.

Banks and other financial institutions have been forced to write down the value of mortgage backed assets which in turn has had the effect of weakening balance sheets and reserves. This raised fears that lenders are trapped in a vicious cycle of falling prices and weakened balance sheets.

Some banks argue that these mark-to-market rules should be suspended and internal models used to estimate the value of assets assuming they are held to maturity. This 'mark-to-model' approach would have the effect of improving their published balance sheets, and remove some of the volatility in the valuation of balance sheet assets.

However, we doubt whether this approach would indeed restore confidence or normality to the financial system. The actual method used to value assets did not cause the current crisis in the mortgage funding markets. The root causes included macro-regulatory failures, the lack of due diligence on the part of investors/ lenders and the lack of transparency in the market.

Moving to mark-to-model (which would involve banks having a significant amount of discretion on how assets are valued) would further undermine transparency in the market and encourage the regulatory arbitrage we are trying to avoid.

4. GOVERNANCE OF FINANCIAL INSTITUTIONS AND ROLE OF LONG TERM INVESTORS

CORPORATE GOVERNANCE AND THE ROLE OF NON-EXECUTIVE DIRECTORS

As we highlight above, the failure of lenders' internal models to assess and control risks, and weak governance structures that incentivised key individuals along the supply chain to behave recklessly contributed to reckless lending in the market.

The role of board directors and non-executive directors in providing the checks and balances to control the behavior of senior management must be questioned. Non-executives in particular are supposed to provide the independent oversight of executive director and senior management behaviour on behalf of shareholders.

But there are concerns that non-excecutives directors either:

- did not understand the risks involved or the new lines of business firms became involved in;
- if they did understand what was going on, did not feel empowered or confident enough to challenge executive decisions;
- alternatively, non-executives may not have been provided with the appropriate level of information to understand risks and exercise due diligence.

In line with our recommendation on improving capability of institutional investors, we urge policymakers to review and improve the corporate governance structures of banks and other lenders and improve the training and competence of non-executive directors.

Firstly, we argue that if banks other financial institutions are to act in the wider public interest then the boards of these institutions must contain independent public interest representatives.

Secondly, we argue that non-executive directors (NEDS) must play a much more active role in holding executive directors to account and managing risk.

However, at a more fundamental level we argue that a review of company law should be undertaken in the UK to evaluate whether it is fit-for-purpose. In particular, the nature of the primary duty directors have to shareholders needs to be reviewed.

LONG TERM INVESTORS

Understandably, the focus of commentators has been on the reckless risk-taking behaviour of the banks and bonus culture that has distorted behaviour and the values of the financial system. Indeed, the banks must be held to account for their role as primary agents in almost wrecking the financial system (under proper conditions banks can be the agents of sustainable wealth creation – this is not an attack on banking or the City of London per se). Our proposals are designed to better align the interests of the banking system with the interests of society, consumers and industry.

But we must recognise that banks were agents of destruction. The capacity for destruction vested in the banks was given to them by society. We delegated the power to the banks and failed to hold them to account so they exercised power responsibly.

How many people in a pension scheme questioned where banks and hedge funds got much of the capital to make reckless loans or invest in toxic assets? Pension fund trustees control a huge proportion of banks' shares on behalf of pension scheme members.

However, the existing regulatory system does not allow pension fund trustees to exercise due diligence on investments. With terrible irony, this has contributed to the financial crash which is now leading to workers losing their jobs, and pension scheme deficits rising.

If markets are to work in the interests of society, regulation is unlikely to be sufficient. To complement the proposals for improving regulation, we propose a range of measures which, if adopted, would enable workers and consumers (through their pensions and investments) to have greater influence over financial markets.

The measures include a combination of statutory and self-regulatory measures covering:

- additional resources should be spent on improving the training and competence of pension scheme trustees;
- the information provided by pension schemes and investment funds to pension scheme members/ consumer-investors must be enhanced – for example, statutory regulation aimed at improving CSR reports;
- pensions legislation relating to due diligence must be beefed up to ensure trustees exercise greater control over investment strategies;
- the governance of pension schemes must be improved by increasing the number of employee representatives;
- new regulations are needed to regulate the conflicts of interest faced by intermediaries such as consultants, investment managers, ratings agencies and advisers who advise pension scheme trustees.

A new comprehensive, 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. This review should investigate: the quality of advice given to pension fund trustees and consumer-investors; the due diligence carrired out by these intermediaries on behalf of clients; corporate governance activities;communication to clients; and level of understanding of complex financial instruments by trustees/ investors.

5. REFORMING FINANCIAL INSTITUTIONS

The final part of our proposals relate to the fundamental role and purpose of financial institutions – particularly the banking sector.

The measures we have set out in the report would improve the way the financial system and financial institutions are regulated and would promote financial stability and reduce the risk of a similar crisis recurring.

However, long term reforms to the financial sector need to be about more than financial stability and prudent lending. The financial services industry - especially the banking sector – is critical to the welfare of society.

Consumers need access to financial services that meet their needs but financial exclusion is a chronic problem in the UK. Far too many vulnerable consumers are effectively denied access to the banking system, access to fair and affordable loans and are underinsured leaving them vulnerable to the risks and shocks life throws at them. Financial security for them is a distant dream, the reality is a nightmare of a life plagued by vulnerability, insecurity and unpredictability.

Industry needs access to affordable risk capital and investment. We need to move away from a system obsessed with short-termism to one that promotes long term, sustainable investment.

However, we think there is a tension in government and regulatory policy. Banks are expected to rebuild balance sheets and lend to consumers and industry. We do not think that this inherent tension can be resolved in the long term. We fear that the tendency of banks will be to focus on providing financial services to consumers who represent a low risk/ are profitable and economic sectors that represent a low risk – strategically important, longer term, higher risk loans and investments will be discouraged.

Overall, we are doubtful that banks in their current form can act prudently, satisfy shareholders, and at the same time promote inclusion and lend on a sustainable, long term basis to industry.

Therefore, we take the view that the time is right for radical reform of the financial services industry especially the banking sector.

In the short term, those banks in which the taxpayer has a stake, and which come under the authority of UKFI (17), should be operated as publicly owned or nationalised banks. In effect, this is what these banks are.

But effective public ownership or nationalisation requires two distinct conditions to be met.

First is the actual ownership of the institution, the second is the effective strategic control and accountability of the institution. However, while we, the public, may in effect own these banks whether directly (as sole or primary shareholder) or indirectly as guarantors of assets, the second condition is not being met.

To be precise, UKFI is supposed to manage the public's stake in the relevant banks. However, it is difficult to understand what exactly is UKFI's purpose and strategic objective. We need a clear, strategic direction supported by strategic objectives.

Moreover, the absence of independent, public interest representatives on the board of UKFI along with an absence of published strategic objectives and reporting mechanisms is a real concern and undermines governance and accountability.

W e make a number of recommendations. UKFI should be given explicit, near-term strategic objectives and priorities. These objectives and priorities are intended to allow these public banks to carry out core public functions and should be seen as preparation for the longer term reforms (see below). These objectives should be publicised along with formal reporting mechanisms to provide accountability.

The government should provide UKFI with the following objectives and priorities:

SHORT-TERM OBJECTIVES

UKFI should after consultation with public interest representatives agree specific and measurable objectives to ensure banks meet their core public interest duties in the following categories:

- lending to industry;
- lending to consumers; and
- financial inclusion.

STRATEGIC OBJECTIVES

In preparation for restoring banks to private ownership, UKFI should adopt these strategic objectives:

- quantification of potential losses and risks in the banks so that we have a better idea of the risks the public is exposed to;
- restoring balance sheets to prudent levels;
- get banks to a position where they no longer need public support;
- restructure the banks so they no longer represent a systemic risk to the financial system (in effect ring fencing these banks);
- identify existing activities within the banks operations that do not meet this core, public interest remit. These activities should be divested or closed;
- prepare banks for reflotation as new, narrow utility banks,

STRATEGIC AIMS

While the long term aim should be to restore banks to private ownership, these new banks must be very different entities.

Banks should be separated into two distinct entities regulated under different regimes:

(17) UK Financial Investments is the organisation set up to manage the taxpayer's stake in banks

- **Common good, utility banks:** whose activities would be restricted to core retail and commercial banking services. These banks would have clear, public interest objectives to maintain access to banking services for consumers and lending to industry.
- **Investment banks:** these banks would be allowed to engage in riskier activities but would be regulated under a much stricter regime.
- **Strategic Investment Bank:** the government should establish a long term strategic investment in addition to the separation outlined aboveand lending bank similar to the ICFC set up in 1945 which became 3i (18).

UTILITY BANKS

The common good utility banks would be expected to conform to social obligations as well as commercial obligations similar to other utilities such as gas, electricity and water companies. To meet the competing priorities of acting prudently and maintaining lending and access to banking services, the return on capital should expected to be closer to that for utilities rather than the level recently achieved by UK banks.

These utility banks would be expected to maintain access to banking services. To ensure this happens, banking services should be classified as a universal service obligation (USO) and enforced by giving consumers a legal right of access to a basic bank account. Access to banking services could be delivered through own branch network or in partnership with other institutions – the Post Office infrastructure is a particularly good option.

An important aspect of financial exclusion has been the disappearance of large parts of the banking infrastructure through widespread branch closures.

Closures exclude low-income consumers from mainstream financial services and can have a devastating effect on disadvantaged communities. Branch closures lead to economic cost and inconvenience to small businesses, the elderly, the disabled and others who are forced to use alternative banking locations/facilities.

Closures can cause a negative multiplier effect and contribute to commercial decline of communities as better off consumers change their purchasing habits along with the need to travel further afield for banking services. Regeneration efforts are undermined. The disappearance of branches based in local communities can make it more difficult for local business to obtain start-up finance or working capital.

Therefore, banks should be required to conform to 'last branch in town' provisions. This means banks would not be able to close a branch if it is the last branch in an economically disadvantaged community unless alternative access to banking services can be guaranteed.

Alternative access in this case could include shared-branch banking model (19), community banks, or viable credit unions. The existing infrastructure provided by the Post Office network provides an obvious foundation on which to build a national community bank network.

The key is that, given the importance of banking services to promoting financial inclusion, access should not be left to the market to decide. The Government should draw up a list of priority communities that need protection – in effect, inclusion 'conservation' areas – and proactively develop alternative, community banking services.

Banks should also be required to conform to statutory disclosure measures similar to those contained in the USA Community Reinvestment Act (CRA). This level of transparency is needed to allow civil society to evaluate the performance of banks against financial inclusion objectives (see below).

INVESTMENT BANKS

Investment banks and the shadow banking system would be regulated under the new system of regulation proposed above given their importance to the financial system and financial stability.

Proprietary trading should be restricted in those banks in which the state currently has a stake. Moreover, under the new banking model, the same restrictions should apply to any financial institution that represents a major systemic risk or is deemed so integral to the UK financial system that it would not be allowed to fail.

A STRATEGIC INVESTMENT BANK

However, we think the time has come to develop more sustainable long term mechanisms to ensure that industry has access to long term risk capital. Therefore, we recommend that the Government a previous idea. In 1945 the FCI and ICFC was created to provide risk capital to independent businesses. This then became 3i (Investors in Industry). The Government should reestablish a new long term strategic investment and lending bank. This institution would be part venture capital fund, part strategic lender. This would not be seen as direct competition for commercial banks. This new institution would focus strategic important, riskier sectors of the economy and promote innovation.

PROMOTING WIDER FINANCIAL INCLUSION

Access to banking services is not the only priority. The UK faces chronic financial exclusion in other areas such as access to advice, affordable credit and insurance. We recommend that government urgently and significantly expand the level of resources available to third sector organisations to develop accessible, fair, and affordable alternative

(18) Investors in industry

(19) As proposed by the Campaign for Community Banking Services see http://www.communitybanking.org.uk/objectives.htm

financial services for excluded consumers.

We urge the government to establish and fund the Social Investment Bank to provide access to sustainable investment and capital for third sector organisations and social entrepreneurs involved in promoting financial inclusion. Furthermore, we urge the government to provide development funding to develop the concept of Social Investment Bonds as a new asset class to channel long term investment and loan capital into community based lenders. For example, if just 1/100th of one per cent of assets held by long term investors was invested in social investment bonds (SIBS) (20) this would provide around £100 million of capital for social investment purposes.

Moreover, regulators should be given a statutory objective to promote financial inclusion. We need much better statutory reporting on the numbers of consumers facing financial exclusion, and on the performance of individual banks.

We argue that the European Commission should require member states to introduce transparency measures similar to those contained in the USA Community Reinvestment Act (CRA). In this case, individual banks should be required to disclose on a quarterly basis:

- number of basic bank accounts in operation;
- number of accounts opened and closed;
- analysis of the profile of customers who have basic bank accounts (location, income, gender, minority ethnic groups and so on (21); and
- complaints from consumers.

At the year end, banks should be required to produce a statutory compliance report on financial inclusion to complement financial report and accounts.

These compliance reports should be independently audited. Self-regulation in the form of corporate social responsibility (CSR) reports is not sufficient to allow performance to be judged.

(20) ISIBs are a concept being developed by The Financial Inclusion Centre as a mechanism for long term investors to provide capital for not-for-profit lenders such as credit unions or community development finance institutions (CDFIs).

(21) Assuming data protection laws allow this

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