Making banks work for us
The case for EU banking reform

A topical discussion on reform of banking and the financial system.

Hosted by Jean Lambert MEP, Green Party Member of the European Parliament for London


Chaired by Jonathan Rosenthal, Banking Editor with The Economist

Held on November 4, 2013 at St Ethelburga’s Centre for Peace and Reconciliation, 78 Bishopsgate, London EC2N 4AG

Event report from Jean Lambert MEP
there is no single issue which has had a greater impact on lives across Europe over the last five years than the 2008-2009 financial crisis.

The crash shone a light on a shocking culture of excess in the financial sector. Irresponsible casino-style banking had spiralled out of control, with fantasy-like sums being risked in opaque transactions of no benefit to the real economy, but with devastating real world consequences.

People across Europe were rightly angered that those responsible for the crisis received a bailout, while others paid through job losses, drastic cuts to public services and tougher economic times. The crisis made the necessity for structural reforms, stronger regulation and supervision of the industry clear.

European Greens have been a powerful force pushing for meaningful reforms - including a successful call for a cap on bankers’ bonuses, a ‘Robin Hood’ tax on financial transactions, greater diversity in the sector, and a return to smaller, community-run banks.

We want banks to be operating for the good of society and the environment - not just their bottom line.

With these issues in mind I decided to organise a debate in the heart of the City of London, bringing together leading banker Douglas Flint, Group Chairman of HSBC Holdings, and Banking spokesperson for the Greens in the European Parliament, Philippe Lamberts MEP.

In front of a capacity audience, at the perhaps-appropriately named St Ethelburga’s Centre for Reconciliation and Peace, the evening offered an important opportunity to look at banking in its broadest economic, regulatory, moral and social context.

A robust but respectful discussion ensued, moderated by The Economist’s banking editor Jonathan Rosenthal.

This report offers a summary of the Green perspective on some of the issues which were discussed.

Please get in touch if you’ve any questions about this event, or would like to hear more about my work as London’s Green MEP.

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This paper aims to reflect the issues discussed during the banking reform debate from a Green perspective, it is not a Green policy paper nor a verbatim account of the event. For further details of Green economic policy please visit:

European Green Party: http://europeangreens.eu
The debate began from a place of general consensus: banks continue to play a central role in the economic life of our society, and how they function matters.

There is need for some sort of financial system channelling investment and operating the everyday transactions on which the economy runs.

Opinion is divided over what the future banking system should look like - and what level of reforms are needed to get there.

For the industry, Douglas Flint placed emphasis on the importance of continued self determination moving forward, pointed out the positive achievements of the system prior to the crash and the regulatory and cultural changes that have already taken place. He believes many of the proposals for further EU level reforms would be damaging to the sector.

But from the Green perspective, Philippe Lamberts stated that the current regulations do not go anywhere near far enough to prevent 'business as usual' and offer sufficient protection from systemic risk - let alone bring about the long term economic and social transformation needed to make banks work for the common good.

The unique position and privilege of the financial industry makes its supervision and structure a matter of public interest, but despite some progress banks still remain 'too big to fail' and under regulated.

In the UK the peak support to banks from the Government was £1.2 trillion\(^1\), with the broader cost to the economy – the true social costs - estimated by the Bank of England’s Executive Director of Financial Stability Andy Haldane to be as much as £7.4 trillion\(^2\).

We cannot allow a situation where this bailout could become necessary again.

Greens want a more diverse financial system, with more smaller community led banks and mutual ownership structures, within a framework which provides incentive for banks to support investment in the sustainable jobs of the future, not a system which is focussed on short term transactions which create asset bubbles and an economy based on unsustainable debt.

The European perspective

When the banking crisis spread to Europe in 2008, there were 27 different regulatory systems for EU banks in place – largely based on national rules and rescue measures. There were no tools to deal with the systemic nature of the crisis. This crisis was not restricted to, or caused by, the single currency, but it was worsened by a failure of sufficient financial sector regulation in Europe and elsewhere.

We believe that achieving stability requires a strong European level policy framework which ends systemic risk and allows more viable, society-serving, reconfigured business models to flourish.

Since the financial collapse of 2008, European policymakers have worked on a significant number of new rules and regulations aimed at making the institutions safer.

This includes a new framework for EU level supervision of major banks in the eurozone (and for those Member States outside the zone who would like to participate), implementation of new bank capital adequacy and liquidity standards\(^3\) (based on the


The Greens in the European Parliament, and across Europe, are continuing to challenge the dominant – and failed – macro-economic framework and press the case for bolder reforms with a social inclusiveness and green industrial agenda.

We need to move towards one planet economics – replacing the assumption that our economy can be based on infinite resources and infinite credit. The framework for an EU wide ‘Green New Deal’ requires much stronger financial regulation and fiscal and macroeconomic policies within the EU.

To begin the transition from an unstable and unfair macro-economic model to a sustainable and socially just framework, stronger policy measures should be put in place immediately. Philippe Lamberts highlighted two practical examples of these:

(a) requiring financial transactions to be funded more through capital and less through debt
(b) tackling the most destructive financial instruments

Greens believe that to increase resilience and end the threat of another taxpayer bailout, large banks should fund their business through more capital and less debt than they have done over the last decade or so. This would rein in reckless lending and increase their ability to absorb losses - cutting the risk to the public purse.

One macro-prudential tool to hedge against this risk is to reduce the leverage ratio - the ratio of debts or assets to equity at which the systemically important banks are required to operate. At the beginning of the 20th century, banks in the US and UK had capital ratios of around 25% (so banks could lend £4 for every £1 owned), but by the end of the century this had fallen to around 5% (£20 lending power for every £1 owned). Prior to the crash leverage ratios fell even further; the ten largest European banks had an average ratio of just 3.1%.

Since the crash the Basel Committee on Banking Supervision (which sets the global banking standards) set out regulations (Basel III) to ensure a minimum capital equal to 3 percent of assets, while UK regulators have proposed an

What needs to be done?

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equivalent of 5% of assets.

Philippe Lamberts made the point that while the average leverage ratios in European banks have risen since pre-crash lows, they are still far too low for comfort - and the existing regulations do not ensure adequate levels of capitalisation to safeguard against further crises.

The need to increase leverage is backed by the findings of the UK’s Independent Commission on Banking chaired by John Vickers, who recommended a ratio of 4% - restricting leveraging up to 25 times. The Commission also called for the Financial Policy Committee of the Bank of England to set the ratio, not politicians.

For the industry, Douglas Flint countered that the need to increase capital will impact on the costs of other financial services such as savings and pension funds. As he put it, the money would come “from a different pocket in society’s suit.”

In addition, he made the argument that the leverage figure does not take into account the higher level of capital support now required by bank customers – such as requiring lower loan to value ratios on mortgages. The British Bankers’ Association warns that a tighter ratio would restrict mortgages and make them more expensive.

But while Greens recognise that ultimately someone has to pay, the need for the “too big to fail” banks to operate with significantly increased capital levels is crucial to ending what Philippe Lamberts described as the ‘moral hazard’.

“\textit{If creditors of banks know that lenders will be rescued by taxpayer’s money, why on Earth should they they behave responsibly? Why should they go to well managed banks?}”

\textbf{Philippe Lamberts MEP}

b. Tackling the riskiest practices

The next question raised was whether we are willing to restrict or ban a number of the riskiest operations used on the market whose positive value to society is questionable to say the least - and which may also pose systemic risk.

Derivatives are financial contracts which ‘derive’ their value from the performance of another asset, index or interest rate. Historically they were designed precisely to reduce risk - to ‘hedge’ bets by providing offsetting compensation - but a proportion of derivatives contracts are used for financial speculation in risky ‘betting’ opportunities.

Some financial products exacerbated problems within the eurozone during its first few years – there is a clear case to be made that some of these opaque financial instruments are symptoms of a system which needs to be brought back to a manageable size. Greens would like to see an end to – or much stronger regulation of - the out-of-control destructive transactions.

Credit default swaps

One of the worst examples is credit default swaps (CDS) – a financial transaction which has existed since the early 90s where the buyer makes a series of payments to the seller, but receives a payoff if the loan defaults. This sounds like a form of insurance, but differs in critical ways, most significantly that anyone can purchase them, even when buyers do not have an insurable interest in the loan (known as ‘naked’ credit default swaps). So you are betting on the failure of a financial product, insuring yourself against a loss you would not suffer. An analogy to this is buying life insurance to cover the imminent death of someone else - but where the purchase may actually ‘aggravate the illness.’

At the start of the crash, large numbers of speculators bought uncovered credit default swaps (CDSs) for bonds issued by crisis countries, further undermining confidence in these countries.

The successful US business investor Warren Buffet described CDS as \textit{“financial weapons of mass destruction”}

High frequency trading

The industry itself is divided over the continued role of a particular class of investors -

10 http://www.parliament.uk/briefing-papers/SN06171/the-independent-commission-on-banking-standards
11 http://www.theguardian.com/business/2012/dec/21/call-strengthen-ring-fence-banks
12 http://news.bbc.co.uk/1/hi/2817995.stm
high frequency traders (HFTs).

No tangible economic benefit seems to be created from these short-term, high-speed computer-to-computer trades which use algorithms to determine what stocks to buy or sell, at mind-boggling speed. High frequency traders may execute 1000 trades per second^{13}, with the speed continuing to rise as technology advances.

Numbers of traders are also rising, with HFT firms estimated to account for 30 – 40% of volumes in equities and futures in Europe, and 50% of the market in the US^{14}.

Unsurprisingly, high frequency trading has a strong impact on the market dynamics, creating instability and damaging runs by speculators. They first came to public attention in May 2010 after the Dow Jones experienced a 9% drop in just five minutes, which recovered ten minutes later^{15}. Academics have found most “flash crashes” are caused by HFT. There is a case that HFT should be banned, or at least much more regulated.

The financial transaction tax (FTT) - also known as the Tobin Tax or the Robin Hood tax - was only touched upon during the debate – but it is an idea whose time has come. There is a huge groundswell of opinion supporting this tiny tax which would help generate revenue to fund the Green New Deal^{16}, curb riskier practices, and make sure the financial speculators whose reckless actions caused the banking crisis pay a fairer share towards its costs. It would also reduce the competitive advantage of the very speculative funds, re-orienting money towards the long term investments required to transform to an environmentally sustainable and socially inclusive society. Third sector organisations are also big supporters of the FTT with campaigners claiming a tiny tax set at 0.05 per cent on transactions could raise hundreds of billions of pounds each year – £20billion in the UK alone.^{17}

The principle of an FTT was backed by the European Parliament with strong support from the Greens in 2011, and after much public and political pressure, the European Commission brought forward proposals for an EU wide Financial Transaction Tax^{18}

The Commission’s proposed tax was designed to impact on the riskier financial instruments and not retail banking, improving transparency and generate significant revenue for more progressive policies at a relatively low cost to the financial sector. The proposal would see a tax levied at 0.1 per cent on share and bond transactions and 0.01 per cent on deals involving complex securities such as derivatives.

Even at these modest rates, the Commission estimated this tax could raise up to £48 billion per year – an enormous sum of money that could be put to good use repairing some of the damage caused by austerity measures.

Since it was first proposed questions have been raised about the feasibility of the tax, and its impact on volatility in financial markets. Yet an academic review of the evidence found that the tax is not only feasible, but if appropriately designed “could make a significant contribution to revenue without causing major distortions”^{19}.

Yet the Commission’s proposals faced fierce opposition from some, not least from the UK Coalition Government. Currently the Europe wide proposals are not going ahead – and the UK even legally challenged moves by 11 eurozone Member States who plan to press ahead with the tax in their own countries, claiming it would impact on the UK economy as branches of banks operating in the FTT area would be eligible to pay the tax.

Will the FTT happen?

Plans are still progressing amongst the 11 Member States who wish to see it, including France and Germany. It is hoped that if it presses ahead...
One of the big points of debate was whether banks were still ‘too big to fail’ five years after the crash reached Europe.

Douglas Flint acknowledged that “too big to manage” was an issue within the industry, but argued that well managed larger banks could also be described as “big enough to cope” - pointing out that it was smaller banks in Ireland and Spain that had faced some of the worst difficulties of the crisis. He also argued that larger multinational banks play a role in social inclusion, opening up opportunities to new markets and individuals, particularly in developing economies.

But as Philippe Lamberts puts it “too big to fail means too dangerous to exist”. There cannot remain a situation where large financial institutions can hold government at point blank, undermining democracy.

Tangible evidence of “too big to fail” comes from looking at the continued, often implicit, fiscal subsidies to the UK’s largest banks.

The Bank of England’s Executive Director for Financial Stability, Andy Haldane, calculated the extent of this subsidy by looking at the credit ratings for the banks. Many agencies explicitly factor in the expectation of government support in their calculations. What was clear was the institutions considered “too big to fail” were given preferential ratings as a result of perceived government subsidy. This translates into a significant monetary value, calculated by mapping from ratings to yields paid on banks’ bonds.

The Bank of England found that large banks accounted for over 90% of the total implied subsidy20.

Using the Bank of England’s methodology the think-tank New Economics Foundation (NEF) calculated the monetary value of the combined TBTF subsidy for the ‘big four’ banks (Barclays, RBS, HSBC and Lloyds) in 2011 to be over £34 billion.

So the bailout was the tip of the iceberg - large banks continue to receive implicit public subsidies from taxpayers, as a direct result of being ‘too big to fail’

### Splitting the banks

To help tackle the ‘too big to fail’ issue, protect and support our economy, Greens would split retail and investment banks and support new institutions like community banks.

Greater diversity and stronger division between types of trading is particularly important in the UK where the banking sector is out of balance with the rest of the economy, and one of the least diverse in the developed world. Local banks make up just 3% of the sector, compared to 67% in Germany or 34% in the USA. KFW - the second biggest in Germany - is publicly owned.

There is not just room, but a need for a wider range of banking models, increased choice and diversity.

We favour the development of more cooperative and mutual economic enterprises, including mutual financial institutions like building societies and mutual insurers, and a publicly owned ‘People’s Bank’ to be created out of one or more of the currently ‘nationalised’ banks, bailed out by the taxpayer21.

In the UK, the Independent Commission on Banking (ICB) headed by John Vickers, published a report which proposed imposing a ‘ring fence’ between retail banking and corporate or investment activities.

Vicker’s report made many positive recommendations supported by the Greens as positive first steps, although we believe much stronger action is required. Yet there is concern that even these modest measures are being too watered down.

The need for stronger restructuring than the proposed legislation was reinforced by the conclusion of the Parliamentary Inquiry into Banking Standards - led by Andrew Tyrie MP. Their report22 called for the ring

> “the too-big-to-fail problem results in a real and on-going cost to the taxpayer and a real and on-going windfall for the banks.”

Andy Haldane, Bank of England

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fence between high street and investment banks recommended by Vickers to be “electrified” with the Government maintaining a reserve power for separation if the proposals are not implemented.

It’s time the UK Government and the EU stopped dragging their heels on these modest reforms.

“The proposals, as they stand, fall well short of what is required. Over time, the ringfence will be tested and challenged by the banks. Politicians, too, could succumb to lobbying from banks and others, adding to pressure to put holes in the ringfence.

For the ringfence to succeed, banks need to be discouraged from gaming the rules. All history tells us they will do this unless incentivised not to.

That’s why we recommend electrification. The legislation needs to set out a reserve power for separation; the regulator needs to know he can use it.”

Andrew Tyrie, Conservative MP, Chair of Parliamentary Commission on Banking Standards

Are salaries still too large?

Excessive bonuses perhaps became the most potent symbol of a banking system that was out of control.

Greens are opposed to absurdly high bonuses and dividends which reward reckless banking.

Green MEPs successfully pressed for legislation to curb the worst excess and apply a cap so that bonuses are not normally higher than base salary\(^23\). Bonus would be deferred for 3-5 years. This aims to ensure people must think of the longer term outcome of their transactions. The bonus cap legislation came into force in January 2014, but is being challenged in court by the UK government\(^24\).

For the industry, Douglas Flint argued that while salaries are still high, the most exotic instruments generating the most extravagant profits have been regulated out of existence. He also made the case for the role of experienced risk managers, pooling risk on behalf of customers, who may play an important role in preventing a future crisis.

However whether there has been real cultural change remains highly questionable. Bankers bonuses soared back up in 2013 (prior to the cap being implemented). Official figures from the Office of National Statistics (ONS) showed a 64% rise in April 2013 compared to the previous year\(^25\). Last year, in London alone the number of bankers earning at least a million euro soared to more than 2,700 – twelve times more than any other country in the EU\(^26\).

Recent research from the CIPD suggests that if the behaviour at the top of the industry has changed, it has not done so enough. The survey found almost two thirds (65%) of all workers in the sector believe some people in their organisation are rewarded in a way that incentivises inappropriate behaviour.

Three in four financial services workers (eight out of ten workers in the banking sector) agree some people in their organisations are still paid excessively\(^27\).

The issue of excessive salaries at the top was highlighted by an independent year long inquiry by the High Pay Commission. Their report found the top 0.1% of earners had increasingly pulled away from the rest of society - since the 80s some had enjoyed a 4000% rise in already generous packages. They concluded the distorted salaries at the top of UK companies can not only reward failure but “damages companies, is bad for our economy and has negative impacts on society as a whole.”

The New Economics Foundation report into pay ratios\(^29\) found there was an absence of evidence to justify operating high pay gaps, and the strong economic and social benefits of fairer distribution - such as a ratio of 1:20 or even 1:10 - far outweighed the costs.

Greens believe that the widening pay gap between those at the top and bottom of corporations must be tackled, as it must be across society. We advocate all workers being paid at least a living wage and an end to the extreme differentials which divide society. We support increased use of co-operative models which distribute more evenly the benefits of economic activities.

\(^23\) http://greenparty.org.uk/news/2013/03/06/city-mep-welcomes-eu-cap-on-bankers-bonuses/

\(^24\) http://www.theguardian.com/politics/2013/apr/25/osborne-bankers-bonuses-eu-cap


\(^26\) http://www.telegraph.co.uk/finance/newsbysector/


\(^28\) http://highpaycentre.org/files/Cheques_with_Balances.pdf

\(^29\) http://s.bsd.net/nefoundation/default/page/-/files/The_Ratio.pdf
This is a debate which has to happen - about shaping the kind of banking sector we want to see in the future. I welcomed the opportunity to discuss the Greens’ perspective with a leading industry expert.

The 2008 crash drove a coach-and-horses through the 700 year old image of a banker as a trusted stalwart of society, prudently looking after our money, and there is much work to be done to restore that trust.

The latest British Social Attitudes Survey shows just how little trust remains in the banking industry. Back in 1987, when the era of financial excess was just kicking off, a staggering 91% of people believed that banks were well run. Now the figure has dropped to 19%.

The figures should be a wake up call that these important institutions are simply not serving society.

Making banks safer and re-oriented to the real economy is the only way to ensure there is no second financial collapse, and to start building a transformation towards one planet economics.

The Green Vision: A Green New Deal

As Greens, we want banks to prioritise long term investment in the skills and infrastructure to create green jobs and transform existing industries to build a low-to-zero carbon, truly sustainable future. We have published policy reports into how our long-term plan for a ‘Green New Deal’ could create six million new jobs and provide a sustainable path out of the crisis, and how it could be funded across Europe.

As part of this, we want to see a resilient, socially and environmentally beneficial and more diverse financial sector – with more small, local and mutually structured banks investing in the real economy, working for the common good.

What is the Green New Deal?

Green New Deal UK: http://www.greennewdealgroup.org
Green New Deal Europe: http://greennewdeal.eu

The Green New Deal is the Greens’ comprehensive response to the current economic, social and environmental crises.

It aims to ensure prosperity and well-being for all, across the planet and generations, based on reducing inequalities within and between societies, and reconciling our lifestyles - the way we live, produce and consume - with the physical limits of our planet.

On the economy, the Green New Deal calls for greater financial regulation and a redefinition of the goals of macroeconomic policy, focusing far more on improving the quality of life and reducing our carbon footprint. It calls for an end to practices which benefit bankers and traders, but damage the real economy and people. It also calls for a tougher crackdown on tax fraud and evasion, and an end to tax havens.

Ambitious and far-reaching fiscal policies should target the enhancement of public services, and generally, be designed to reward sustainable practices and make unsustainable commercial activity and lifestyles disadvantageous from a tax point of view.

Support for the Green New Deal

“The green economy already employs nearly a million people, in areas from electric-car manufacturing to wind-turbine installation. Implementing some of the ideas in this [Green New Deal] report could help these industries create more of the skilled and well-paid jobs we need if we are to build a sustainable recovery.”
Frances O’Grady, TUC General Secretary

“There is a simple but powerful point at the heart of the Green New Deal. We have enormous untapped capacity and underemployment in the economy alongside huge unfulfilled needs for investment in clean technology, skills and homes. To fail to connect the two is a kind of economic masochism, and this [Green New Deal] report sets out a credible alternative plan of action.”
Tony Greenham, Head of Finance and Business, nef (the new economics foundation)
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