An alternative report on UK banking reform

A public interest report from CRESC

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The report is dedicated to C. Wright Mills who studied unaccountable elites and defended democracy.

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Executive summary

1. In the aftermath of the financial crisis, many want more radical banking reforms than those proposed by the UK government and the Conservative opposition. Moderate Financial Times columnists agree that current reforms will not make finance safe; senior regulators like Adair Turner and the Governor of the Bank of England raise fundamental questions about the size and usefulness of the financial sector. The public expects something to be done about bonuses while it waits for public expenditure cuts now required after the bail-out wrecked public finances.

2. The UK government has added some rhetoric about bonuses but not moved beyond its timid proposals in the July 2009 White Paper *Reforming Financial Markets* which is inadequate. This report explains how and why there is such a gap between the political classes and expert demands or the public mood. The report also examines what can be done to assert greater democratic influence over financial markets.

3. The inaction of government results from the influence of the 'distributive coalition' in and around the City of London, which has co-opted the political leadership of both major parties. The alignment of finance and politics works because the crisis has reinforced government reliance on finance insiders to form policy and frame choices.

4. Current and ex-investment bankers and fund managers took key positions in the process of crisis management and resolution after 2007. At the same time, HM Treasury and the Mayor of London commissioned reports from the same City finance groups about the importance of maintaining the competiveness of London as an international financial centre.

5. The resulting Bischoff and Wigley reports represented a new kind of politics where finance reports on finance by telling stories about finance. Bischoff group members collectively had 662 years of work experience and 75% of those years were spent in City occupations or servicing City needs. Wigley called expert witnesses but 90% of its witnesses came from finance or consultancy with revenue links to finance.

6. This represents a break with earlier pluralist practice in inquiries into finance from the Macmillan Committee of 1931 to the Wilson Committee of 1980.

Here multiple points of view were represented on the committee and in written and oral evidence which produced "balanced" reports. In the case of Macmillan, dissents plus reservations and addenda accounted for one-third of the pages in the final report.

7. The distributive coalition around the City of London frames political choices through the insider reports. Bischoff and Wigley construct a narrative about the 'social value of finance' in terms of tax contributions, job creation and the diffusion of prosperity. This inhibits reform because the policy implication is that nothing should be done that inhibits competitiveness.

8. Through the buy-in of leading politicians like the Chancellor and through copy-out in official reports like the July 2009 White Paper, the end result is a kind of regulatory closure because problem definitions are framed by elite members of the distributive coalition and the world of possible policy interventions is narrowed as radical options are painted out.

9. Closure has not been achieved when senior regulators like the Governor of the Bank of England or the Chair of the FSA openly question the social value of finance. But the distributive coalition has co-opted leading politicians from both major parties who need the City's political donations and need the City's success story which justifies their political *a priori* about a transformed, strong post Thatcherite economy.

10. The major obstacles to reforms for safer and sustainable banking are political not technical. The solution is not to insulate reform from elite politics but to promote reform through democratic politics. Broader social representation on committees and regulatory boards is vital if unaccountable elites are to be questioned. But effective representation requires greater knowledge and perspective about what finance is doing and should be doing.

11. It is important to challenge the distributive coalition's narrative about the social value of finance, which makes exaggerated claims and uses evidence selectively:
    i. The tax revenues from the finance sector in recent years are offset by the immediate cost of bank bail-out. In five years up to 2006/7, the finance sector paid and collected £203 billion in taxes, but the upfront costs of the UK bail-out are £289 billion, rising potentially to £1,183 billion.
    ii. In terms of job creation, the finance sector directly employs no more than 1 million workers (mainly in retail) and numbers employed do not increase

in the boom years. If we add jobs in consultancy, accounting and law sustained by finance, the number of those directly and indirectly employed by finance still accounts for no more than 6.5% of the UK workforce.

iii. The business model of wholesale banking and the geographical clustering of wholesale activity, together ensure that the finance sector concentrates rather than diffuses employment opportunities and prosperity across the UK. Retail banks control the costs of high street jobs, while wholesale pulls a small number of well-paid financial actors towards its centre.

In its present form, finance is a pro-cyclical activity with limited job creating capacity and a proven ability to disrupt the economy at great cost to the taxpayer.

12. Banking delivers little social value and instead operates ‘for itself’. Under pressure for shareholder value, banks overcame the handicap of high fixed costs, intensifying competition and low spreads. They did so from the 1990s onwards by pushing into new activities like proprietary trading in wholesale and mass marketing in retail. They created a new sectoral business model that fused retail and wholesale through securitization and turned banking into a giant ‘transaction generating machine’.

13. Financial innovation allowed senior wholesale bankers to expand transactions and turnover, increasing bonuses and fees by trading complex derivatives. Meanwhile the drive for shareholder value in retail banking encouraged an incentivised workforce in the high street branches to “sell to” retail customers who provided the wholesale markets with feedstock. The outcome of this *bricolage* was inherently fragile with long, convoluted circuits where one retail transaction could generate many fee earning opportunities.

14. This ‘transaction machine’ created huge amounts of unsustainable shareholder value in the bubble years when finance and insurance accounted for more than 30% of all FTSE 100 profits and British banks sustained Return on Equity of 15-25%. Corporate governance was an ineffectual brake on risk-taking which was actively encouraged by a dysfunctional joint venture between wholesale ‘talent’ and shareholders. The ‘comp ratio’ was an explicit understanding that, the wholesale workforce was entitled to around 45% of net turnover.

15. Amongst the many invisible and unremarked problems of retail was an unlevel playing field which systematically disadvantaged mutuals and smaller firms. Mutual building societies pay higher costs of deposit insurance and all smaller banks are handicapped by the requirement to buy clearing services

from an existing clearing bank. The incumbent major PLC banks are protected by their branch systems which are both barrier to entry and a basis for cross selling to a customer base which is still more likely to divorce than to switch current account provider.

16. The problem of the pre-2007 bubble was not that there was too much debt, but that too little credit was applied in the right places. The finance sector undermined sustainable growth by inflating asset price bubbles rather than underwriting any kind of productive investment. Productive business investment remained at a steady 10% of GDP between 1996-2008, but declined sharply from 30% of all bank lending towards 10% as banks expanded their lending on property and to other financial institutions.

17. Put another way, the UK has an economic co-ordination problem because all debt is ultimately a claim on future resources, and the sustainability of debt in one phase is linked to the amount of resources that an economy can create going forward. Finance allocated capital to (leveraged and unsustainable) asset price growth and not into productive, socially useful investment that might generate the sustainable returns to support debt repayments.

18. Despite its track record, the distributive coalition now borrows the language of social innovation to argue that new financial products can address 'unmet social needs' such as care in old age. This implies more funds routed through the wholesale markets which would benefit the senior workforce, but could well increase economic instability without solving our social problems.

19. Any challenge to the extension of financial markets will meet political resistance from the distributive coalition around finance who are hostile to anything that crimps their own money making activity. If banking reform is to succeed, it will only do so by building a political alliance for reform which makes immediate demands that are intelligible and actionable and develops a mobilising vision of sustainable finance.

20. Most reports on banking end with a list of recommendations chosen from the menu of policy measures currently being discussed. These stock measures include separating retail and wholesale, sharply increasing capital adequacy requirements and inventing a new practice of macro prudential regulation. But many of these measures will predictably be frustrated by the distributive coalition and we should not make choices now which pre-empt democratic discussion.

21. Hence, we offer 'principles for action' which are coherent with our problem definition and suggest a political direction for travel without specifying the technical details of intervention. If we consider immediate reform demands, the four principles for action below are designed to increase the accountability of financial elites and the transparency of their activity as well as to transform retail mass marketing:

    i. *Top slice the lump of revenue now allocated to the senior wholesale workforce under the comp ratio system* which gives them the right to nearly half of net turnover. Claiming 25% or more of the comp fund is politically justifiable because it was elite traders who created the fragile system that failed, and because it recompenses taxpayers for state funds spent on bailing out banks and markets. The proposal is to create a smaller comp fund rather than regulate how banks distribute bonuses.

    ii. *De-risk the sector by simplifying wholesale and explicitly engineering shorter transaction chains*. This could be addressed via a Tobin tax which puts sand into a system that currently seeks to increase the volume and value of transactions for senior workforce gain with little obvious social benefit.

    iii. *Shrink the sector by reversing the long standing policy bias in favour of finance.* Introduce 'no favour' policies because wholesale activity is not so valuable that it justifies concessions over low effective tax rates for high income bankers or disclosure exemptions for their corporate vehicles. Greater transparency is a necessary prerequisite for a more democratic finance. Encourage shrinkage by reducing rather than increasing the flow of feedstock from retail by, for example, preferring graduate tax to student loans.

    iv. *Introduce a new kind of regulator in retail, broadly advised by a retail banking committee drawing on the expertise of SMEs, Trade Unions and NGOs.* The regulator would have a broad brief to include extending the range of advice available in high street banks and curbing banking business models that are currently too sales-based. A different regulatory regime in retail finance would build on the competences and motivations of the retail workforce which restricts sales performance-related pay.

22. Beyond these principles, there is a need for a mobilising vision about how a different kind of finance could design sustainable circuits between credit and debt and apply credit to our unsolved problems. This opens up new possibilities for different approaches to job creation in a low carbon economy. Possibilities here include state sponsorship for projects which meet social and environmental needs, new industrial contracts with indicative investment and employment goals, or tax breaks for green or other socially useful technologies. Other major problems about security in old age could be addressed by channelling savings directly into lower yielding infrastructure projects and low carbon technologies that would meet social needs, reduce the intermediary clip and switch funds out of the secondary shares market.

23. If we are to reassert democratic influence over finance, it is necessary to raise big questions and suggest imaginative solutions. However the democratic process should not be abridged. Hence this report's principles and vision are all subject to subsequent debate, decision and action within a democratic process.

1. A political view of banking reform

How has Britain reached the current impasse on banking reform, what programme of reforms is necessary and what can be done politically to mobilise for effective reform after the crisis? Before our report takes up these questions, this short introductory section observes the current blockage on reform and presents an alternative view of the political obstacles to reform. The message is that reforming financial services is a democratic problem: it is above all about weakening the grip of unaccountable financial elites on our political system.

The roller coaster ride started in autumn 2008 with extreme intervention by UK and US governments as they faced a collapsing financial system; it ends in autumn 2009 with muddled inaction by UK and US governments who are apparently powerless to deliver a safer financial system. This section begins by describing how the power and credibility of national governments diminished in these twelve months –after starting with immediately effective, state-led stabilisation following the Lehman crisis in autumn 2008. But this intervention was hugely costly and had ambiguous longer term consequences. As a result, by summer 2009 politically negotiated attempts at banking reform were increasingly timid and ineffectual.

These problems are widely recognised in media commentary on the growing pile of British reports on financial services reform: they started with the Turner Review and various Treasury Select Committee reports which include some radicalism and end in a White Paper which promises to change very little.

Our report is different in three fundamental ways:

(1) *This report argues that the primary obstacle to banking reform is not the technical difficulty about what to do but elite political resistance to doing anything radical.* The distributive coalition around the City of London has spun a story about the social value of the finance sector whose competitiveness must therefore be maintained. Senior politicians in both major parties have been co-opted into doing nothing by way of (re)regulation which would hinder finance's continued success. In section two of this report we show how the story about the social value of finance was copied out from the Bischoff Report and was then used as a framing device in the White Paper of July 2009. The end result is regulatory closure insofar as radical policy alternatives are painted out. The implication is that

reform is being blocked by a deficit of democracy and we need to make our financial and political elites more accountable.

(2) *This report challenges the City's story about the social value of finance and presents an alternative activity and business model analysis of how shareholder value has promoted banking for itself.* In section three of this report we show how the taxes paid by the finance sector are offset by the costs of bail out and analyse the pattern of employment whereby finance concentrates rather than diffuses prosperity. In section four, our alternative analysis shows how shareholder value has promoted banking for itself over banking for the outside customer who requires intermediation or risk management. Retail banking has become mass marketing to households which then provides the feedstock for wholesale banking which has become proprietary trading. Thus banking becomes the great transaction generating machine, enmeshed in economic and social relations which are unsustainable and dysfunctional for everybody except the elite workforce whose bonuses are the result of a kind of joint venture with the shareholders

(3) *This report argues that the deficit of democracy is part of a more fundamental failure of social imagination about what finance could and should do to diffuse sustainable prosperity.* Section five of this report proposes immediate reforms which are politically intelligible and actionable. These immediate reforms include changing the policy bias in favour of finance and introducing specific measures to shrink and derisk wholesale banking as well as imposing a new kind of regulator on retail banking. Section six of this report develops a mobilising vision of how a different kind of banking could diffuse sustainable prosperity. Our problem before 2007 was not too much credit and debt but the wrong kind of credit and debt as UK banking fed dealing and asset price inflation rather than productive investment. Our alternative vision is of a finance which would help sustain jobs and pensions through investment in infrastructure and low carbon technologies which would increase the resources for repayment.

With these points made we turn in the rest of this section to an overview of where the UK is on banking reform in autumn 2009 and how we got here.

1.1 Governments and the crisis: from 2008 to 2009

In the extremity of crisis, states were the only institutions combining both the economic resources and the legitimate authority to stabilise the financial system. In all the different jurisdictions this was boldly addressed in an uninhibited way starting with Troubled Asset Relief Program (TARP) in the USA and Hank Paulson's initial couple of pages

asking for $700 billion. Much in the US and UK had to be improvised. Mistakes were inevitably made, especially when it came to interventions like bank nationalisation which had previously been unthinkable: the British government dithered on intervening to save Northern Rock in autumn 2007 and the US mistakenly let Lehman go under in September 2008.

The interventions stopped the chain of institutional failures and market seizures were palliated. Maybe the amount of fiscal stimulus was not large enough, and the monetary policy instruments could have been differently combined, but a broadly expansionary policy stance was maintained. Policy makers in crisis were uninhibited because they quickly and at huge cost did what they previously said they could not and would not do; and they thereby avoided policy mistakes which would have led immediately into another Great Depression with domino bank failures and high mass unemployment.

Immediately following the crisis came a chorus of "never again" demands for government to deliver safer finance. However, the subsequent reform packages were negotiated in a more complex way through the due process of politics, involving finance industry lobbyists and competing regulatory agencies. So what elected politicians should or could do quickly became blurred through lobbying, consultation and bureaucratic in-fighting. By summer 2009, there was widespread public disappointment with the scale and scope of reforms envisaged in the US and UK Treasury White Papers. In both documents, radical proposals for breaking up large complex financial institutions had vanished from the agenda, and were replaced with much more timid proposals: for instance, plans requiring somewhat higher capital adequacy ratios that were not yet disclosed.

Meanwhile, lobbyist pressure ensured the watering down of the first modest and sensible proposals for immediate reform. This is what happened to US proposals for exchange trading of derivatives and to European Union (EU) proposals for more disclosure by alternative investment funds. Few had believed promises about concerted international action, but many were disappointed by manifest division between different governments, especially in the EU where the French and the British were (predictably) on different sides. Against this background, policy makers were being blamed for indecisiveness by commentators who believed the bubble and crisis would happen all over again. In Financial Times (FT) editorials and columns by Willem Buiter, John Kay and Martin Wolf (e.g. 24th June 2009) the moderate commentariat argued that reform needed to go further if it was to be effective.

At the same time, the stabilisation of winter 2008-9 looked increasingly less heroic because it was achieved at huge cost to the taxpayers, while policies like bank nationalisation were increasingly muddled. The UK Treasury was reticent but the IMF calculated in mid-2009 that saving the finance sector had cost the UK taxpayer several hundred billion pounds; the costs of bail-out in the US were dramatised by media comparisons which pointed out that saving finance had in real dollars cost the US more

than the Louisiana Purchase plus the New Deal, the space race to the moon and several other identity defining US programmes. In the UK, the crisis had a wrecking impact on public finances: the public sector deficit ballooned from 3 to 13%, with the grim prospect of public expenditure and employment cuts after the 2010 general election.

It also transpired that politicians had dished out money and guarantees without imposing any clear terms and conditions on the bankers who had got us into the mess. Gross conflicts of interest arose in the US when Goldman alumni were involved in the decision to bail out American Insurance Group (AIG) and incidentally saved his old firm Goldman Sachs from counterparty disaster. After non-transparent stress testing in the UK and questionable stress testing in the USA in spring 2009, survivor banks issued new stock as their share prices recovered, and started to repay TARP money allowing bank managements to announce business as usual. After extreme intervention in the US and UK, several major financial firms had been nationalised or part-nationalised and were under direct government control by early 2009; but that only raised the unanswered, and embarrassing, question: control for what purpose?

1.2 What to do next?

After the panic nationalisation of UK banks, the government did not know what to do except to run them for shareholder value before selling them off. State owned banks like RBS and Northern Rock behaved like any private bank and nationalisation was reinvented as a private equity style turn around. The chief executive of RBS will earn an incentive payment (Long Term Incentive Plan –LTIP) of £6.9 million if he doubles the share price (FT 23rd June 2009). That is perfectly alright by UKFI (UK Financial Investments Limited –the state holding company for nationalised banks) because the "overarching objective [is] protecting and creating value for the taxpayer as shareholder" (UKFI, 2009, p.13). It is not clear is whether the banks have been nationalised or the Treasury has been privatised as a new kind of investment fund.

Meanwhile, it is not so much business as usual but better than ever for the surviving (privately owned) investment banks. Governments have become major bank customers which must fund fiscal deficits and act to stabilise financial markets; a smaller number of investment banks can now earn high margins on this new prime business with guaranteed access to liquidity from central banks. Goldman Sachs, Barclays, JP Morgan Chase, HSBC and Royal Bank of Scotland all earned bumper profits on their investment banking businesses in the first half of 2009. Deutsche Bank and Barclays began hiring investment bankers and maybe offering guaranteed bonuses to new recruits. Barclays was unapologetic about paying large bonuses to existing staff, which was justified on grounds that it was necessary to reward "talent" (FT, 3rd August 2009).

There is no shortage of official reports in every jurisdiction arguing about what went wrong and how it should now be fixed by reform of banks and markets. In the UK, Lord Turner and the Financial Services Authority (FSA) provided an influential first review;

the independent Treasury Select Committee (TSC) published no less than nine reports into aspects of the crisis; and in July 2009 and the Treasury published its own White Paper, *Reforming Financial Markets,* while David Walker published yet another report on better governance. In these official reports, as in their US counterparts, the crisis and the fixes for crisis were presented as primarily technical matters that required a new mix of regulatory policies.

But the technocratic impetus for reform is weakened by difficulties well beyond the everyday political hassles about turf war between agencies like the Bank of England and the FSA, plus uncertainty caused by the prospect of a new Tory government in 2010. Most experts agree on the desirability of a new kind of "macro prudential regulation" but the Bank of England then has to struggle with problems of conceptualisation, data measurement and modelling before it has developed a new regulatory practice that works. If the technocrats cannot deliver an expert solution quickly enough to gain the initiative, the senior regulatory elite has also begun to raise fundamental questions about the appropriate size of the financial sector and the social value of finance.

These issues entered public discussion in autumn 2009 after earlier hit and run comments by key regulators. The Governor of the Bank of England in his 2009 Mansion House speech noted *en passant* that the finance sector was "too big" and Lord Turner of the FSA used a Prospect round table to reiterate his point that some finance was "socially useless". Our report takes up these issues at length and more systematically by examining the City's self justifying narrative about the value of finance. It does so in two ways: First, it analyses how the post crisis reiteration of the City narrative in the Bischoff and Wigley reports promoted regulatory closure in 2009; second, it presents evidence which shows how the City narrative exaggerates fiscal benefits and job creation, thus grossly overstating overstating the social value of finance.

1.3 Insiders and outsiders

Whether or not finance is socially useless, it is undoubtedly very effective politically as long as the issues are contained within the world of high politics around the Whitehall and Westminster villages. Hence, there is growing media criticism of the role of insiders and of finance lobbyists who are rightly identified as a key obstacle to effective reform. The July 2009 publication of the anodyne Walker Report on better governance in finance crystallised these misgivings: Gillian Tett of the FT observed on the Today programme that the Walker report had little credibility because it came from an insider; while Philip Augar in an FT *op ed* column (19th July 2009) blamed the more general failure to consider alternative structures and wider options on "the government's decision to use insiders to lead and inform its response".

Our aim is to substantiate, clarify and refine these criticisms before taking them further with argument and evidence. The aim of taking the politics out of finance is a naïve technician's dream because in any discussion of the future of finance "we are not in

business at all, we are in politics" as Walter Hallstein argued in a different context. But democracy is denied insofar as post-crisis problem definitions and acceptable solutions for finance are being subordinated to the requirements of the distributive coalition around the City of London, which has enriched itself out of the new wholesale in investment banking and fund management.

The near monopoly of speaking parts by elite finance insiders and their political hostages is challenged by the authors of this report who are outsiders *vis a vis* these processes. The practitioner authors of this report are businessmen from old style venture capital, mutually owned manufacturing, the retail banking trade union, the leftist end of activist governance and management journalism. All are unlikely to be rung up by HM Treasury and invited onto the next working group. The academic authors come from heterodox political economy and political science not mainstream economics or finance and they are based at the CRESC research centre, University of Manchester in the UK's second city which has a proud tradition of independent political thinking and innovative organisation.

This network of friends came together in summer 2009 to discuss the crisis and its aftermath and then write an entirely unfunded public interest report. As individuals we had elements of analysis and then together tried to construct a synthesis in a series of informal and overlapping meetings of practitioners in London and academics in Manchester.

1.4 Opening democratic debate

Our hope is that this report will encourage debate about a new more political approach to banking reform in the UK. This requires much more than adding a few token representatives of organised labour, NGOs, women or minorities to existing committees and advisory boards. Before this can have any effect, the authors of this report believe we need a broad debate about the socio-economic role and function of finance in the economy and society. This is a preliminary to defining a politically robust (non-City of London) agenda for the future of finance in wholesale and retail. We aim to encourage debate by highlighting different aspects of the national blockage on reform and the attempted regulatory closure before illustrating the possibilities of alternative ways of thinking, different political demands and new kinds of mobilisation.

It is important to be clear about what this report does not cover and why. Given our aim of highlighting political obstacles to reform, our report does not present a comprehensive account of the causes of crisis which would be central to any technical report. An analysis of causes would involve weighting the role and interaction of financial innovation, macro imbalances and regulatory failure. In turn this would highlight the international dimensions of the crisis and the difficulties about co-ordinated or joint government action which will be problematic or ineffectual for the foreseeable future. At which point we would remind our readers that we promised not *the* alternative report but

an alternative report which needs to be complemented by others which take a different object.

Our focus on the nation is pragmatic and political. We do not believe that the problem of banking is co-terminous with national boundaries or that the levers of reform are to be found within national boundaries in a world of varieties of capitalism. Indeed towards the end of the report we highlight the difficulties caused by the combination of foreign bank lending in the UK and UK banks lending abroad. But in the present state of European integration, all the different European nations are like Tolstoy's families 'unhappy in their own way'. And this is a report on the British form of unhappiness because ours is still 'a family with the wrong members in charge'. Much has changed since Orwell originally made that charge, but the events of recent years show that the charge is if anything more apposite: there has been a huge increase in the power and influence of financial elites over the rest of us.

The remainder of the report is organised in five sections. It begins with a first section on regulatory closure before turning in sections two and three to consider the limited social value of banking for itself and then analyses banking as the great transaction generating machine. The last two sections deal with policy issues and choices, beginning with the political resistances to radical reform of wholesale and retail and then turning finally to the need for a vision of sustainability which answers some big national questions.

In each of these sections, our aim is not to offer exhaustive analysis but to present some basic empirics and make a series of key arguments. They all provide material for wider debate and should encourage a shift from complaints about political obstruction of reform to argument about how and why the sphere of politics must be extended in order to achieve reform. The debate should include and involve actors from the old politics of parties, organised labour and employers as well as the new politics of NGOs.

We expect that many will disagree with some of the positions argued in this report and the authors expect to come under friendly fire. At the same time, we are also trying to choose our enemies carefully and discriminatingly. This report is not an attack on finance but on the distributional coalition that now speaks for finance and is based in the core activities of investment banking and fund management and the head offices of the giant conglomerates like Barclays and Deutsche Bank. It is an attack not on investment banking but on the new wholesale of prop trading, and it is an attempt to raise issues about marketing driven retail banking which is the basis of the conglomerate form.

We hope that many, including thoughtful senior managers in banking and finance, will see the force of the democratic arguments about banking with a social purpose and accept that giving banking elites everything they want is no way to run a democracy.

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2. Going for closure: the Bischoff and Wigley reports

This section analyses an attempt at regulatory closure by UK financial elites who co-opted senior politicians and moved for closure with the Wigley Report of December 2008 and the Bischoff Report of May 2009. In these two reports, the distributive coalition around finance deflected reform and defended the status quo by reworking narratives about the social value of finance. These post-crisis narratives painted out alternatives and confirmed the political classes in their established view that the (socially valuable) finance sector should be encouraged and could not therefore be upset by intrusive re-regulation to prevent crisis. The political world of possible reforms is then framed by a new Treasury doctrine: the importance of not upsetting finance.

We should note that this kind of regulatory closure is not the same thing as regulatory capture. The idea of capture is promoted in public choice economics where firms seek to capture regulation and selfish, rent seeking special interests usually win at the expense of an indifferent public. As analysts of closure, we envisage a more complex and cultural world where stories are used to motivate political actors. Narratives often compete so that closure is a kind of special case not an inevitable result. Another difference is that the antidote to closure is democratic participation and openness prior to effective re-regulation because analysts of closure have no dogmatic bias against government intervention: the way to compete with a bad story like Bischoff is to tell a good, convincing one.

This section also considers broader current and historical issues about who writes on finance and who questions finance. If the distributive coalition was able to speak for finance, their effort was facilitated by the incapacity of other independent groups. Knowledge is the key input for any functioning democracy, so media and technical experts play a crucial role by informing social debate and empowering political choice. But the aftermath of financial crisis shows how difficult it is for these groups to play their role effectively: to produce appropriate and empowering knowledge for others when the socio-technical issues are complex.

The media and finance experts who should have defined and defended a public interest were in different ways themselves disempowered by the complexity of the crisis or complicity in the crisis. Consequently, many honest journalists failed to turn the crisis into an intelligible new(s) story about necessary reform. The technical experts could not immediately recover from their own disastrous

knowledge failure in the pre-crisis years when they had gone along with the bankers' own story about the benefits of financial innovation.

2.1 Journalists and experts

The post 2007 crisis was different because it was the first metropolitan capitalist crisis with 24/7 media coverage. In many ways this only served to illustrate the bias against understanding that is inherent in such coverage of complex issues. Mass audiences were quickly familiarised with arcane technical terms like securitisation and derivatives and the new bail out language about "troubled assets" or "bad banks". But mass understanding was limited because the media was incapable of turning the crisis as *actualités* into any kind of big picture narrative which would sustain a problem definition that was accessible to the public at large, and that could motivate democratic political action.

Crucially, the crisis was so complicated that it was hard to identify one crucial failure that was its cause, or one best way of bank design or re-regulation which would guide reform. The unprecedented growth of wholesale finance relying on mass retail as a feeder ensured that many different types of investment and retail banks failed for different reasons in the USA and the UK. Countries like Spain and Canada, whose banking systems were relatively unscathed, had different institutional histories and regulatory practices.

The serious analysts like Gillian Tett in the FT and Robert Peston on the BBC produced a continuous commentary on such complexities. This brought out the nuances for Radio 4 and broadsheet readers but not the big picture for the wider public. Most of the mass media defaulted onto scapegoating of underserved bonuses and unrepentant individual bankers. The high spot of UK media coverage was the Treasury Select Committee's grilling of the failed bankers. Fred Goodwin and Andy Hornby (like Dick Fuld in the US) offered television audiences the red top version of catharsis.

The technical experts had a different problem after the crisis because they were coping with the legacy of unexpected, massive knowledge failure that discredited and disoriented their pre-crisis claims to expertise built on mainstream economic theory. Queen Elizabeth's question about the crisis was "why did nobody see it coming" (Daily Mail, 6th November 2008). Central Banks and regulatory agencies in the UK and USA were as culpable as everybody else, because their experts and technocrats had accepted the wholesale bankers' story about the benefits of financial innovation, credited Black-Scholes algebra with a heroic role and misrepresented derivatives as a "marketisation of risk" which made the financial system more robust.

After the event, mainstream finance academics had very little to say about the crisis except that, as John Danielsson argued before the TSC (26th February 2009), their technical formulae had been misunderstood and misapplied. Many regulators recognised that some kind of paradigm shift in knowledge was now required. The FSA's Turner Review canvassed a shift to behavioural finance and the investigation of irrationality. This was problematic for academics or regulators because it would have made their intellectual capital and 'quants' skills partly redundant. Against this background, the expert of the moment is Andrew Haldane who comes from an orthodox economics background, is financial stability director of the Bank of England and proposes a more imaginative paradigm shift.

Haldane's gambit (April 2009) is to understand the financial crisis through the lens of epidemiology and ecology, as the behaviour of a complex, adaptive network. His change of metaphor defines a whole new intellectual and policy agenda about "mapping the network" and "vaccinating the superspreaders". But this has repercussions for what Haldane has called the "big new idea" of macro prudential regulation which figured prominently in UK, US and EU official reports. If Haldane's paradigm shift is taken seriously, the macro-prudential is knowledge repair and conceptual work in progress not an immediately operable set of control technologies. The incapacity of serious experts and honest journalists then opened the way for an attempt at closure by a distributive coalition from the City of London.

2.2 Business and government relations

The transition from normal to extraordinary politics after the collapse of Lehman was both a threat and an opportunity for the financial elites. In normal politics, it is easy to overestimate the significance of common backgrounds or interlocking business networks when the everyday issues are usually about detail changes in the rules of the game on which elites are often divided. But, in extraordinary politics, a loose coalition can powerfully influence outcomes when business elites are defending their position against the possibility of changes to the game.

This second section of our report explains how the distributive coalition moved for closure in the Bischoff and Wigley reports by monopolising the speaking parts, reworking the established City narrative about the social value of finance and selling it to the political classes from where it predictably inhibited reform. But, these processes need to be set in historical context with an initial overview of business government relations.

Our analysis starts not from the greed of the bankers and fund managers but from the needs of the political classes after Thatcher.

- First, since the Major years of the early 1990s, every aspirant and credible UK opposition party has needed new sources of funding and political contributions. The City was always the largest source of corporate and individual donations, as

John Smith realised in the early 1990s, when Labour embarked on its "prawn cocktail offensive". The atrophy of class politics also loosens business identification with centre right parties and encourages 'Murdochisation' as smart businessmen tactically switch their financial support to whatever party is going to win the next election.

- Second, every UK government since Thatcher in the second half of the 1980s has presided over an anaemic private sector and needs economic success stories so that it can claim to preside over a strong, successful economy, thereby justifying the pain of marketisation and growing inequality. The story of the transformed economy under the Tories morphed into the story of the strong economy under Blair and Brown whose claims were of course accepted by Cameron and Osborne before the crisis. Sectors like finance had an opportunity to tell stories of economic purpose and social achievement to politicians and civil servants, who wanted to believe and deferred to business success.

Structural changes in business and government relations also made narrative much more important. Before Thatcher, corporate business had been organised into trade associations which pursued their objectives by formulating sectional demands or withholding co-operation within structured planning processes like incomes policy. After Thatcher, trade associations declined because they had nothing to negotiate. The trade associations were supplanted by DIY representation by individual giant firms and by sectoral coalitions of firms organised in an *ad hoc* and minimalist way. The new kind of lobbying worked differently because single firms and sector coalitions both told stories as a way of motivating political action. Business and government relations entered a new Scherezade phase where PR functionaries and lobbyists told stories as a way of postponing unpleasant consequences.

The opportunities of the Scherezade phase in the UK were greatest for the two sectors of pharmaceuticals and finance. Both were dependent on favourable regulation and could also claim to be generating taxes, employment and exports when most of British manufacturing was cutting back. The City was reincarnated not as an organised fraction of capital but as what Edwards (2009) calls a distributive coalition which subcontracted the story telling to individual firms and to the City of London Corporation. The story about the many benefits of finance was a way of motivating the continuation of the established policy stance of encouraging City expansion which continued after New Labour won the 1997 election. The story about social benefits was then attached to a changing set of immediate demands which shifted over the conjuncture. Immediately before the crisis, the City was actively pressing the case for safeguarding the "competitiveness" of the City through less regulation. This was the message of the 2006 Deloitte Cost of Regulation Report which counted the (high) cost of regulation.

2.3 The Bischoff and Wigley Reports

After 2007, the distributive coalition used the old story for new defensive purposes through the Bischoff and Wigley reports which brought together city elites and co-opted two key political figures. The first report was co-chaired by Win Bischoff, former chairman of Citigroup and by Alastair Darling as Chancellor of the Exchequer. The second report was commissioned by Boris Johnson as Mayor of London from a group headed by Bob Wigley, European chair of Merrill Lynch.

The two reports arose out of the pre crisis high politics of financial lobbying and were ostensibly not about the causes of crisis or about the solution of re-regulation. Bischof's report was effectively commissioned in July 2008 (HM Treasury, press release, 74, 2008) when the Treasury set up a new group to report to the High Level Group on City Competitiveness which had existed since 2006. The Bischoff report's remit was "to examine medium to long term challenges to London's continued competitiveness in international financial markets" (HM Treasury, press release 47, 2009) and the Wigley Report was a "review of the competitiveness of London's financial centre". This provided the opportunity for a two step analysis. In a first step, the reports updated the old story by recounting the contribution of financial services to the national economy; and then in a second step, the City identified the conditions necessary to maintain this valuable activity which incidentally included something like the regulatory status quo.

This syllogism was powerful because the political classes on both front benches had a bad case of Stockholm syndrome –the syndrome by which those encaptured identify emotionally with their captors. After the crisis of 2007-8, the Bischoff and Wigley reports encouraged their continuing identification with their captors. This was manifest in the processes of *buy-in* and *copy-out*:

- First leading politicians explicitly bought into the syllogism about the social value of finance and made a commitment to nurture the sector. In his foreword to the Bischoff Report, the Chancellor of the Exchequer writes that "financial services are critical to the UK's future" (Bischoff, p.2). In a press release accompanying the Wigley Report, the Mayor of London says "Bob's team have identified what needs to be done and I will pullout all the stops to protect London's position as the world's premier financial centre".
- Second, the social value claims from the Bischoff Report are copied out and used as a framing device in other official reports, especially the July 2009 White Paper on *Reforming Financial Markets*. In its first chapter, the White Paper begins by reviewing not the causes of crisis but "the importance of financial services and markets to the UK Economy and the pre-eminence of the UK as a global financial centre" (2009, p.17). Claims and evidence from Bischoff are simply copied out and dropped into the text of the White Paper, which reproduces the story and unsurprisingly ends by proposing nothing radical.

The White Paper represents what we call closure: that is, it operates by framing, and narrowing, the political world of possible interventions. The White Paper is important because its copying out of Bischoff's claims indicates that senior civil servants have been co-opted, just like elected politicians, through the narrative of the City as the goose that lays the golden eggs. The old Treasury doctrine of the inter-war years was the futility of public works regardless of what John Maynard Keynes wanted. The new Treasury doctrine is the impossibility of upsetting the City, regardless of what the FT's columnists and Adair Turner want.

2.4 Excluding other voices

In the next section of this report we will challenge Bischoff's and Wigley's evidence about the social benefits of finance. But here we will note that the analysis and *a priori* in the Bischoff and Wigley reports were not challenged by internal dissent (for example in the form of a minority report) because the distributive coalition monopolised the speaking and writing parts which together produced the two reports as a kind of performance.

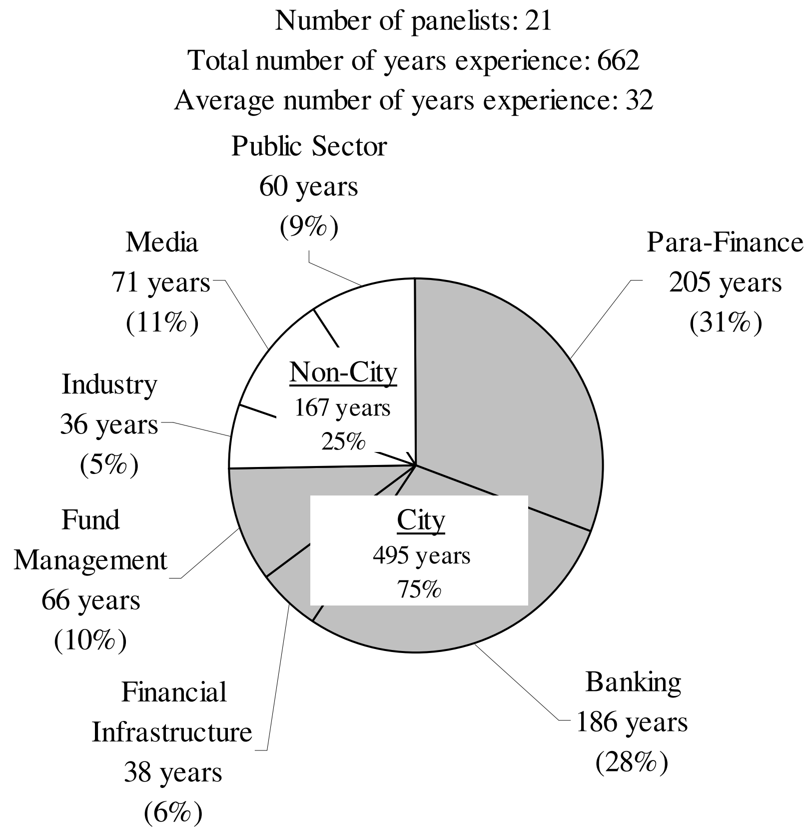
Many other groups have an interest in the operations of wholesale finance both in itself and because it connects with the availability of retail finance; while wholesale and retail are of course, organisationally coupled in financial conglomerates. But none of these other interested non-City groups were consulted in the information gathering, problem defining phase before Bischoff and Wigley told their story about (the benefits of) finance and drew their policy implications. Membership contained no non-financial businesses and their trade associations, no trade unions despite the unionisation of retail finance workers, no NGOs to represent consumers or press social justice agendas, no mainstream economists or heterodox intellectuals, very few politicians or civil servants.

The exclusion of other voices and the privileging of finance can be empirically demonstrated in several ways if we consider the membership of groups, the composition of secretariats and the witnesses called.

- The fairest bit of the Bischoff Report was its sub-title "a report from UK based financial services leaders to the Government". The working group that produced the Bischoff Report had twenty one members whose biographies we have analysed. Altogether the group of twenty one members had 662 years of work experience which are classified in the pie chart in exhibit 1. Taken together, finance and para-finance support services accounted for 75 % of all the years of work experience, with banking and fund management alone accounting for 38% of those years of work experience. This calculation understates the influence of finance if we remember, for example, that the Confederation of British Industry is represented by Richard Lambert, an ex journalist with a thirty year career in

"media" which was actually at the Financial Times, the UK's national paper of finance.

Exhibit 1: **An analysis of the Bischoff Report**



Source: Publicly available information on the members of the Bischoff working group

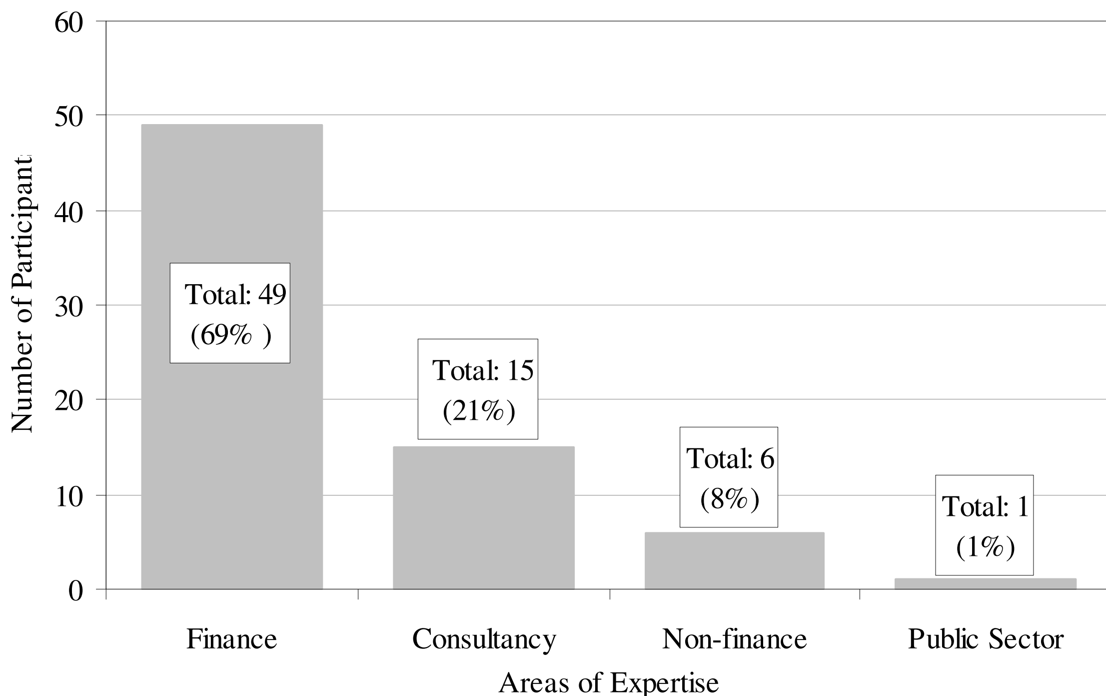
- The secretariat and research arrangements are even more interesting, especially in the case of Bischoff. This was an officially published report, crown copyrighted and available on the Treasury web site. That might lead readers to expect a report that was drafted by civil servants. In fact the "secretariat" and the "sherpas" were overwhelmingly drawn from the distributive coalition. The eight strong secretariat contained just one civil servant and four employees from Citi plus three from the City of London Corporation which has traditionally acted as a booster for finance. The Citi contingent was led by Alan Houmann, Director of European Governmental Affairs and the City of London by Paul Sizeland, Director of Economic Development. So the Bischoff Report was researched and written by the functionaries of finance PR and lobbying who have made careers out of telling stories which postpone unpleasant outcomes for their employers.

- Wigley called witnesses whereas Bischoff did not. But the calling of witnesses makes little difference because Wigley's witnesses were overwhelmingly drawn from the same distributive coalition as working group members or secretariats.

These question and answer sessions were a matter of finance speaking to finance. Altogether, Wigley called seventy-one witnesses whose expertise we have classified. The bar chart in exhibit 2 illustrates the quite striking results. Of the 71 witnesses, some 49 came directly from finance and a further 15 came from consultancy activities which generally have revenue connections to finance. Quite remarkably, the public sector provided just one witness: presumably the knowledge and expertise of HM Treasury or Department of Business Enterprise Regulatory Reform were irrelevant to the story that Wigley told about the importance of defending this valuable activity.

Exhibit 2: **Wigley Report -an analysis of the expertise of the witnesses**

Total number of witnesses: 71



Source: London: Winning in a changing world –interviewees and workshop participants list

2.5 Historical differences

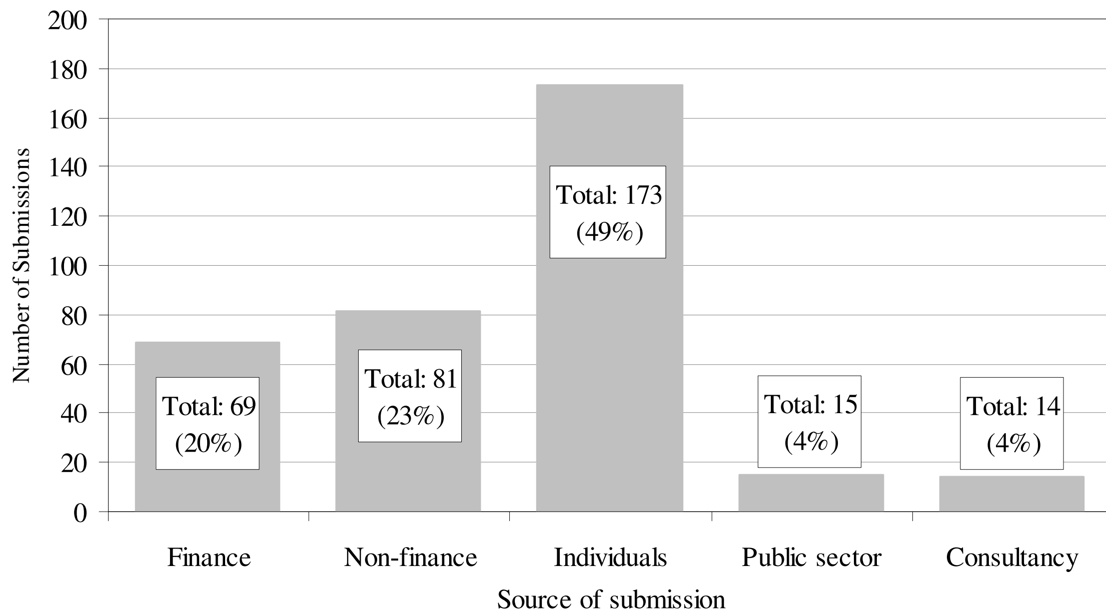
The UK has become a very peculiar place where the main employers' organisation is headed by a retired financial journalist and where finance company lobbyists can include authorship of Treasury reports on their CVs. This was not always so; our democracy once worked very differently and more effectively before Thatcher and Blair's aversion to dissent assailed it.

It is interesting to compare Bischoff and Wigley reports with earlier major reports into the operations of the City, the choice of financial policies and the role of finance in sustaining business and economic progress. The Wilson Committee into the Functioning of Financial Institutions (1980), the Radcliffe Committee on the Working of the

Monetary System (1959), and the Macmillan Committee on Finance and Industry (1931) variously considered these issues. Several key points of difference stand out, if we benchmark Bischoff and Wigley against the inclusive practice of representation and the pluralist notion of the report in these earlier classic inquiries:

In terms of representation, committee members in pre-1979 inquiries were a diverse group with academics, elected politicians, trade unionists and industrial employers seriously represented. The standard practice was then to initiate and sustain debate by inviting written submissions and hearing evidence from witnesses who represented a broad range of interested groups.

If we consider the Wilson Committee, for example, it received 352 written submissions which are analysed in the bar chart below in exhibit 3.



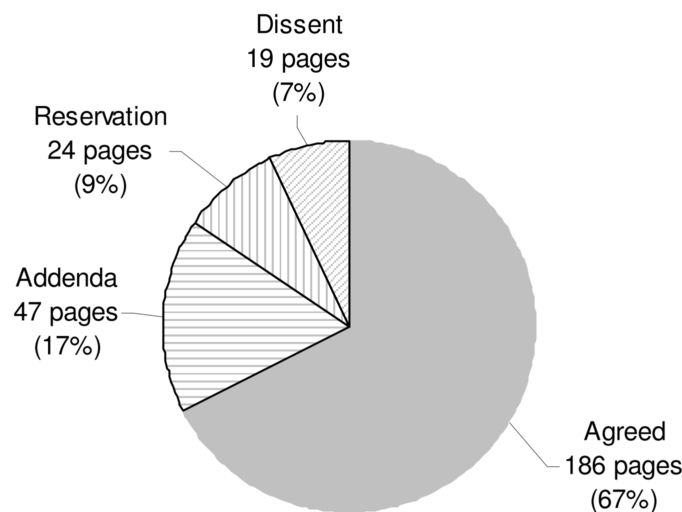
Source: Committee to Review the Functioning of Financial Institutions
(Report – Appendix 1 Organisations and individuals who submitted evidence)

Some 173 submissions or almost exactly half came from individuals who were not directly speaking for organisations; as for the written submissions from organisations, the 81 written submissions from non-financial organisations actually outnumbered the 69 submissions from financial organisations. The Wilson committee's membership, like its written submissions or oral hearings, represented a practice of politics. Harold Wilson's committee on the city, just like his Labour Party, included and balanced different points of view which were performed at every stage in the inquiry. By way of contrast, Bischoff and Wigley develop and push one view point to the exclusion of all others.

If we consider final reports, practice again changes quite fundamentally because the pre-1979 reports are often messy, inconclusive and pluralist. Public inquiry before Thatcher was legitimately a forum for intellectual debate and political differences not a Bischoff style attempt to impose a narrative wrap and pitch one story which will compel belief and justify (pre- existing) policy choices.

This is most clear in the case of the Macmillan Committee which discovered the "Macmillan gap" in funding for medium-sized companies through a vigorous contest of views. The Macmillan Committee members included heavyweights such as John Maynard Keynes and Ernest Bevin, the outstanding trade union leader of his generation. The views expressed in written submissions and oral testimony ranged all the way from Governor Norman's inarticulate Bank of England orthodoxy to Major Douglas' cranky Social Credit. All this was represented in the final 276 page report whose structure is analysed in exhibit 4 below.

Exhibit 4: **Analysis of the Macmillan Report**
(Total number of pages 276)



Source: Committee on Finance and Industry (Report)

This exhibit shows that dissent, reservation and addenda to the majority report accounted for one-third of the pages in the full report. Thatcher and Blair would no doubt have regarded this is a hopeless failure but the Macmillan Report represents a healthier pluralist outcome than the Bischoff and Wigley reports.

2.6 The Treasury Select Committee

Against this background, our current political system puts a quite unreasonable burden on the Treasury Select Committee (TSC) whose independent critical role is both a recent constitutional innovation and the last stand of an old tradition of public life. The TSC operates under huge constraints. The Committee is grossly under resourced, inhibited by

two party politics and subject to para by para negotiation of reports, with no procedure for checking back on implementation of previous recommendations. It has limited influence on policy formation in a system where it can be dealt with by being ignored. The committee's chair, John McFall has performed a considerable public service under these conditions.

The absence of adequate resourcing was manifest in the TSC's first report into the financial crisis which borrowed the Turner Review's problem definition about macro-economic imbalances and then added a company by company account of what went wrong. This report only served to reinforce the "bad bankers" stereotyping encouraged by the Committee's own public roasting of Fred Goodwin. The lesson of all this is not that the TSC has failed but that we cannot expect too much from one Select Committee without a much broader constitutional reform: a reform which rediscovers and resources some old values of public debate; one which promotes a different kind of political practice that encourages disagreement; and one which provides institutions designed to enforce accountability, like the Treasury Select Committee, with the resources adequately to do the job.

In the meantime, on banking and finance, the fixing of our broken democracy requires more than formal representation. Effective social participation depends on understandings that challenge the narratives of the distributive coalition in finance; and mobilisation then requires immediate demands and visions of what finance could do.

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3. Questioning the value of finance: taxes paid and jobs created

The Bischoff and Wigley reports are of enduring interest because they represent a political practice which is a danger to our democracy. Irnically, they did not achieve regulatory closure because they co-opted the politicians but could not incorporate the regulators. A handful of technocrats in top positions know they can express provocative views without being punished. We are all obliged to the Governor of the Bank of England and the Chair of the FSA who have used their privilege in a constructive way. In late summer 2009, Adair Turner as chair of the FSA reasserted his previously expressed view that some financial innovation represented "a socially useless activity" and tilted towards the idea that the wholesale financial sector was too big (Prospect, September 2009, p.36).

Mervyn King's and Adair Turner's dissent has encouraged debate about the social value of finance and in this section we take this debate forward by presenting some relevant evidence which allows the reader to judge the claims of the distributive coalition about the social value of finance. This knowledge allows us to challenge the established narrative about finance as the 'goose that lays the golden egg'. Our argument is that Bischoff and Wigley exaggerate national benefits partly by misleading arithmetic. Their reports add the benefits of taxes paid, exports generated and employment created by finance but decontextualise the figures and exclude the costs of an activity whose net social value is modest or negative.

Our research below recalculates tax benefits and contextualises jobs created, but does not consider evidence about exports and finance's contribution to the balance of payments. This would require technical discussion of complex income and capital flows and stocks which would be historically beside the point when it was not finance (but North Sea oil) which covered the payments consequences of the UK's manufacturing failure. Our discussion of jobs and taxes is also fairly factual. A Brechtian commentary on the coalition's narrative would instead focus on the hypocrisy of a finance sector which publicly counts its taxes paid after privately investing huge amounts of time and money in structuring transactions and corporations for tax avoidance.

As our argument develops in this section, it will become clear that we are debating not only the size and usefulness of the finance sector but also the future shape of the British economy. The UK now needs to address the issues which Peter Mandelson raised in his sound bite about how Britain "needs an economy with less financial engineering and more real engineering" (Times Online, 28th January 2009). The antithesis was borrowed from Thomas Friedman, a New York Times columnist (20th September 2008) who had sharply observed that the derivatives bubble was unlike previous bubbles in that it left no legacy infrastructure like a railway network or the internet. These large issues about the purpose of finance are taken up in the sixth and final section of this report.

3.1 Methods of calculation

Many academics would prefer to set calculations of cost and benefit in some kind of formal methodological frame like cost benefit analysis which assigns a money value to all relevant costs and benefits and adjusts for the time value of money. But even in relatively simple single project appraisal the precision of the final bottom line is undermined by the cumulation of guesstimates and proxies on the intermediate lines. The

technique was classically undermined by its own application as when the Roskill Commission's cost benefit on the location of London's third airport entered the value of the Norman Church at Stukeley as £50,000 which was its fire insurance value. It is of course hugely more difficult to list and value all the costs and benefits attached to a sector like finance.

We prefer some form of political arithmetic using an empirically resourceful and conceptually minimalist approach used by right and left academics more than thirty years ago, when authors like Bacon and Eltis (1978) or Ajit Singh (1977) debated not whether Britain had too much finance but how and why it had too few industrial producers. This approach fell into disuse with the rise of formalisation in 1980s economics discourse even though it has many strengths. These include an interest in primary sources, and in the conceptual problems of how official statistics developed in one set of categories can be used to develop arguments about something else. For political arithmetic, the impossibility of any comprehensive and accurate count of all costs and benefits is no great problem because analysis can work by critically deconstructing claims and assumptions in pre-existing stories.

3.2 Bischoff and Wigley count the benefits

At this point we can return to the Bischoff and Wigley reports which developed the story line about the economic and social benefits of City activity and were then copied out in the Treasury White Paper. Bischoff and Wigley's calculation of the social value of the finance was itself, in methodological terms, a carry over. The two reports did little more than present empirically up-dated versions of the crude "add the benefits" calculation which the City of London Corporation had been using right through the 2000s as a way of justifying the established public policy of supporting the growth of the finance sector.

Before or after 2007, the sector's own calculation about the national benefits of finance in the UK added up the contribution of finance under three headings: balance of payments contribution, taxes paid and employment created. The political premise here is that, size matters. If addition produces big numbers, the political classes will be impressed by size which puts the social contribution of finance beyond question and will counter any criticism of wholesale finance in the City.

The arithmetical problem is that calculation by addition has an inherent bias because it inevitably accentuates the positive and eliminates the negative. The sector's own calculation does not consider how negative costs counterbalance positive benefits when taxes paid are balanced against the subventions required by finance. The sector's own calculation also presents simplified headline interpretations after selecting job numbers from complex data sets about all the different sources of jobs created in the national economy. As we argue below, the effect of both edits is the same because the sectoral calculation exaggerates benefits and does not consider the pro-cyclical costs.

3.3 Taxes paid versus costs of bail out

Let us therefore present some recalculations about the net fiscal contribution of finance before turning to contextualise the employment figures. We may not be engaged in formal cost benefit analysis but we start by recognising that the activity of the finance sector is generally two sided in terms of fiscal contribution. On the one hand, the finance sector pays taxes especially in good times; and on the other hand, the finance sector also imposes costs on other taxpayers insofar as the sector requires market subvention, system guarantee and corporate bail out when things go wrong. The relative size of the positive and negative and their net effect will of course change over time and is a matter for empirical calculation. If we consider the UK in the 2000s, our empirics below immediately suggests that there is cause for concern.

- Taxes paid by finance have to be estimated because no official source directly gives a total for taxes paid by the sector. The Wigley Report imputed the tax contribution of the finance sector by using methods derived from a PwC study for the Corporation of London. Wigley used this method to estimate taxes paid in one year, and we have used the same method to estimate taxes paid by the financial sector over five years. The table in exhibit 5 shows the total of taxes paid by finance over five years from 2002-2007. The five-year total is £203 billion which includes £101 billion of taxes borne plus £102 billion of taxes collected (principally income tax and national insurance). This is a large total partly because there is a strong bubble effect when government tax revenues from the finance sector rise by almost 50% after 2002.

Exhibit 5: **The financial service sector's tax contribution to the UK**

	Taxes borne				
	Corporation tax £mill.	Employer's national insurance £mill.	Business rates £mill.	Irrecoverable VAT £mill.	Total £mill.
2002/03	7,405	4,966	1,248	2,725	16,344
2003/04	7,691	4,894	1,282	3,114	16,981
2004/05	8,758	5,903	1,316	3,446	19,423
2005/06	11,439	6,571	1,352	3,644	23,006
2006/07	12,351	7,614	1,388	4,179	25,531
Total for 5 years	47,644	29,948	6,585	17,107	101,284

	Taxes collected				Grand total tax borne and collected
	Employee taxes and national insurance £mill.	Stamp duty £mill.	Insurance taxes £mill.	Total £mill.	£mill.
2002/03	12,962	2,593	2,138	17,693	34,037
2003/04	12,599	2,559	2,294	17,452	34,433
2004/05	15,000	2,715	2,359	20,074	39,497
2005/06	16,355	3,485	2,343	22,183	45,189
2006/07	18,524	3,757	2,314	24,594	50,126
Total for 5 years	75,441	15,109	11,448	101,998	203,282

Source: Derived from Nomis, HMRC, ONS and PricewaterhouseCoopers

- After the bubble bursts, the UK government has to pay for the bail-out and the most up to date and authoritative estimate of bail out costs is provided by the International Monetary Fund (IMF) in the July 2009 report by Horton *et al.* whose calculations are summarised in exhibit 6. The IMF calculates the "direct up front financing" cost to the UK taxpayer as £289 billion including here the cost of the Bank Recapitalization Fund, the Special Liquidity Scheme and the cost of nationalising Northern Rock and Bradford and Bingley. But if we add all Bank of England/HM Treasury loans and guarantees, the IMF calculates the potential cost as £1,183 billion.

Exhibit 6: **The IMF's calculation of the UK Treasury's subvention of the banking sector** (Announced level of support)

	Announced cost of subvention (as at April 2009)				
	Total £mill.	Per head of UK population £	Per UK household £	Share of GDP (2008) %	Percent of public expenditure %
Capital injection	56,398	919	2,230	3.9%	9.7%
Purchase of assets and lending by the Treasury	199,564	3,251	7,891	13.8%	34.2%
Guarantees	718,718	11,709	28,419	49.7%	123.3%
Liquidity provision and other support by the Bank of England	208,240	3,392	8,234	14.4%	35.7%
Total	1,182,920	19,271	46,774	81.8%	203.0%
Upfront cost	**289,223**	**4,712**	**11,436**	**20.0%**	**49.6%**

Source: Source: Derived from 'The State of Public Finances: A Cross-Country Fiscal Monitor', IMF Staff Position Note, July 2009.
Notes: The table does not include the £185 bill provided by HM Treasury to support the Bank of England's operations (12.8% of GDP) and 'upfront cost' refers to actions that required direct government outlays.

> As all the guarantees have not been used the actual cost is between £289 and £1,183 billion and certainly well above the base figure of £289 billion. These upper figures of £1,000 billion or more are so surreally large that they are difficult to comprehend. If we guesstimate the final actual cost as £550 billion, that is nearly £10k for every person resident in the UK or just under £35k per family. In terms of public expenditure, £550 billion is roughly the size of the total public expenditure budget for 2009, 10 times the schools budget and 6 times the total spend on health.

The cost of post-crisis subvention so far is manifestly larger than the sector's tax payment in recent years; after this experience, a prudent accountant would then probably recommend setting aside all the finance sector's future tax receipts as provisions to cover the cost of subvention when things went wrong. The cost of subvention will of course be reduced by subsequent sales of stakes in part and wholly owned banks But that is itself cause for concern because it encourages civil servants to extract the highest price by selling off assets without confronting the underlying problem that the sequence of tax payments, bail outs and asset sales suggests that the state is only manoeuvring around uncontrolled subsidy for a pro cyclical sector. From this point of view, the issue is not the size of the finance sector in itself but inflated wholesale and its unsustainability which increases the social risks and costs of finance

The surreal logic of this problem is that the state should increase its own capital requirements (at the expense of current expenditure on services and jobs) so that it can better manage the cyclicality of finance.

3.4 Job creation?

Given the unfavourable public revenue and cost figures, it is doubly disconcerting to find that the UK gets relatively little in return by way of job creation. On the issue of employment, the arithmetic of Bischoff and Wigley is not so much illogical as frustratingly incomplete partly because the employment contribution of finance is peculiarly difficult to understand and measure from the available figures.

The finance sector includes wholesale finance in the City, retail utility banking and insurance across the country. The sectoral employment totals for finance conflate two different classes of bankers: the masters of the universe in the City and the disposable white collars on the high street. Furthermore, the boundaries of the sector are increasingly blurred. The finance sector like others is vertically disintegrating and therefore we must consider not only finance employment inside the finance sector but also para-finance employment in other sectors which is sustained by demand originating in finance. The main issue here concerns the amount of general business service employment which is sustained by demand from the financial sector.

After considering these complications, we have reviewed the direct evidence on finance sector employment, added estimates for para-finance employment. Three key points immediately become clear:

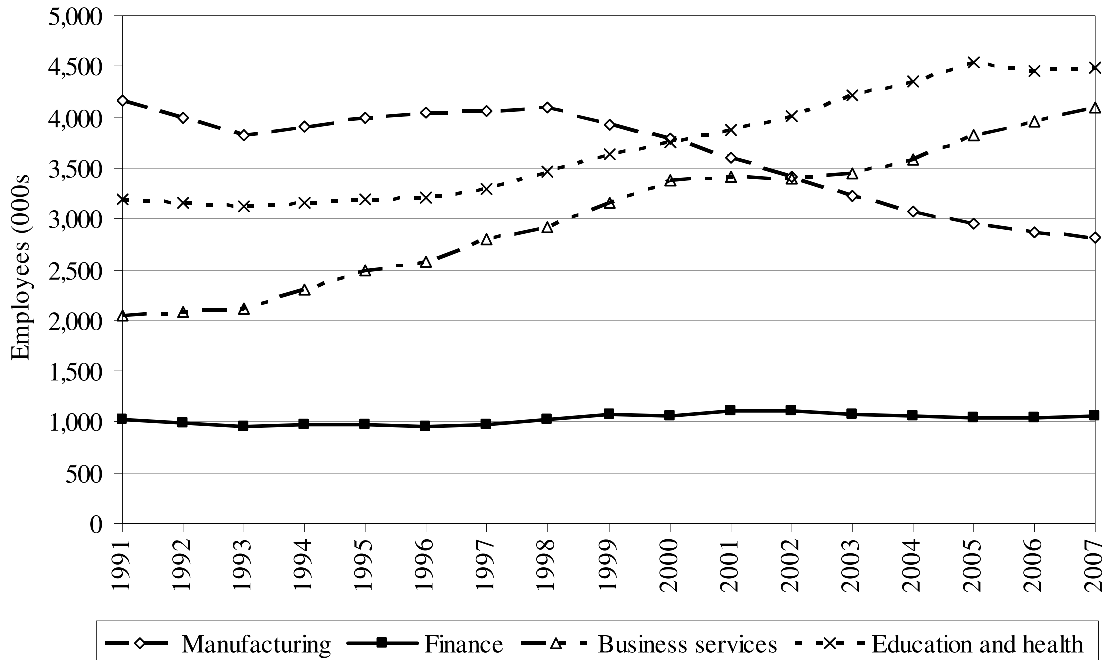
(1) Despite rapid expansion of finance output and profits from the mid 1990s, the total numbers employed in the finance sector were more or less flat, at 986k in 1992 and 1,054k in 2007.

The graphs in exhibit 7 below set this modest total and flat trend in context. The total of one million directly employed in the finance sector is less than half the total of those employed by British manufacturing in its current emaciated condition and no more than a quarter of those employed in manufacturing ten years ago. The trend of financial services employment is flat while there has been a huge expansion in business services employment where employment has nearly doubled from a base of two million in the early 1990s towards four million at present.

Why are there so few jobs in financial services? The explanation is rooted in business models and activity characteristics, so that the finance sector, which accounts for 8% of output, accounts for a share of the workforce that is declining towards 4%. Retail employees on the high street are a cost to be reduced by banks pursuing shareholder value; while one wholesale employee can lift a lot of money in the City of London so

that only a small number were ever enriched through City bonuses and fees. The activity characteristics in wholesale are reinforced by a business model in investment banking which, as in law and accounting partnerships, is designed to generate high incomes for a small number. The practice of the investment banks is to increase the numerator by ramping up 'prop trading' activity while limiting the denominator by operating a form of labour market closure so that relatively few new recruits are hired and those in post are promoted under an "up or out" system of culling.

Exhibit 7: **Comparison of UK employment in selected sectors**



Source: Nomis (from the Annual Business Inquiry), ONS
Note: Includes changes in SIC classifications

(2) Numbers employed are not hugely increased by adding on para-finance and out of sector employment sustained by demand from finance. On our estimates, direct employment in the finance sector plus indirect employment in para-finance together account for no more than 1.5 million workers.

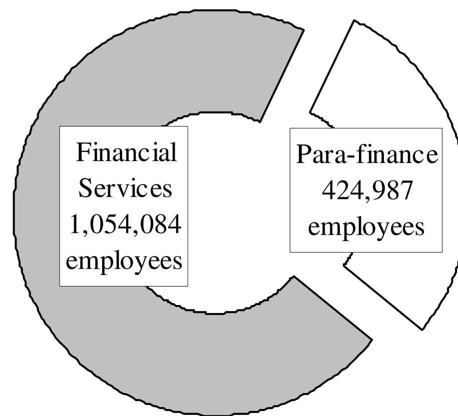
UK call centres or data processing centres providing services for retail finance are counted inside the finance sector; we do not think there is a large para-finance component in general business services which does include, for example, call centres working both for finance and other companies. The wholesale sector does generate significant employment in law, accounting and consultancy. But on our estimations, in exhibit 8, adding para-finance employment only increases the numbers employed in and by finance to a total of around 1.5 million or 6%-6.5% of total UK employees.

Why does finance generate so few jobs outside finance? The numerical effect is limited for several reasons. The main beneficiaries in para-finance are a relatively small number of high earning partners in law and accounting. More fundamentally, the limits are set by

the nature of finance activity because the retail selling or wholesale trading of an immaterial product simply does not require the kind of supply chain support necessary to activities like manufacturing or other kinds of retail. More generally, immateriality is important because the product is often expansible at low cost, as when a credit rating agency uses a standard template contract to rate any number of new derivatives.

Exhibit 8: **Financial services and para-finance employment in 2007**

Total employment: 1,479,071



Source: Nomis (from the Annual Business Inquiry), ONS

(3) Regionally, the effect of finance is to concentrate rather than diffuse prosperity. The distributed nature of retail and continuing wholesale activity in the North is counterweighted by the intense centrifugal forces around wholesale finance in London.

- The various official reports emphasise finance's regional contribution and it is true that retail employment is distributed and there are significant concentrations of wholesale activity in the North-West and Scotland: these two regions together employ just over one quarter of the finance sector workforce. But that is less than half the story. From 1998-2007 finance sector employment actually decreased in the South-East, South-West and Eastern regions; and finance sector employment also decreased in all the London Boroughs except Tower Hamlets. Exhibit 9 presents our calculations and shows that, for example, the direct increase in finance employment of 45,000 in Tower Hamlets (which includes Canary Wharf) was balanced by an employment loss of 33,000 in all other London boroughs.

- Wholesale finance is an island of wealth surrounded by much deprivation in the capital and the expenditure of the wealthy few has strong but narrowly focused impact on house prices in select London suburbs and on luxury goods and

services whose production and distribution has a high import content and does little for deprived Londoners. Meanwhile, the finance lobby's aggressive and successful demands for infrastructure expenditure like Heathrow Terminal 5 and Crossrail threatens to further unbalance regional development.

Exhibit 9: **Analysis of intra and inter-regional employment change in the finance sector between 1998 and 2007**

London and the surrounding regions

	Employees
East	-14,074
South East	-17,372
South West	-1,560
London	12,186
Net change in finance sector employment	-20,820

London boroughs

	Employees
All London boroughs except Tower Hamlets	-32,909
Tower Hamlets	45,095
Net change in finance sector employment	12,186

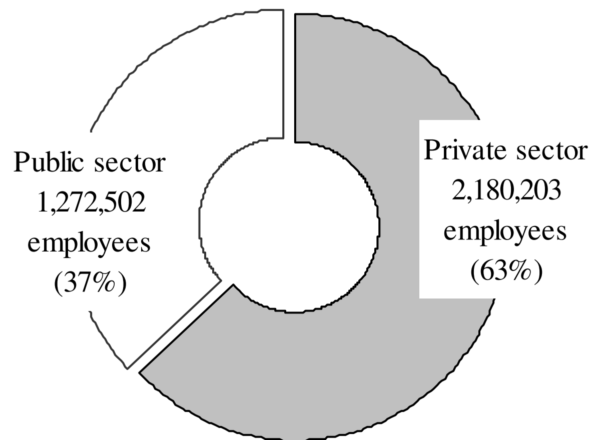
Source: Nomis (from the Annual Business Inquiry), ONS

All the argument and evidence above is about the finance sector as whole. If we consider banking more narrowly defined then all the totals are simply much smaller. The time series evidence on banking employment is not particularly informative because it shows an increase in employment in the mid-1990s, which is caused entirely by reclassification of an existing workforce when the building societies converted into banks. According to British Bankers Association statistics the "UK banking industry" provided employment for just 432,000 at the end of 2006 or just under half of those directly employed in financial services in the first-half of the 2000s. Nearly 80% of the employment in "major British banking groups" was actually in retail activity and most of that would exist even if Canary Wharf was derelict.

3.5 The indirect contribution: boom and bust

In the decade before 2007, the main contribution of finance to the national economy was indirect. The boom of unregulated credit creation boosted tax revenues and allowed New Labour to increase expenditure on health and education services favoured by swing voters. Incidentally, these policies then expanded state and para-state employment because service delivery was inherently labour intensive and the employment gains were distributed right across the country. On our estimates, state and para-state employment together accounted for 37% of all employment growth from 1998-2007 (exhibit 10).

Exhibit 10: **UK employment growth 1998-2007**
Total increase in employees: 3,452,705
(includes full and part-time)



Source: Nomis (from the Annual Business Inquiry), ONS

These broadly distributed gains had a very variable impact in the different regions. As exhibits 10a and 10b demonstrate, the public sector crucially accounted for more than half the employment creation in ex-industrial regions like the West Midlands and the North East. In such regions, there was effectively no private sector job creation under New Labour other than that driven by the regional multiplier effects from consumption spending by state and para-state employees.

Exhibit 10a: **North East**
Employment growth by sector 1998-2007
Total increase in employment: 120,670

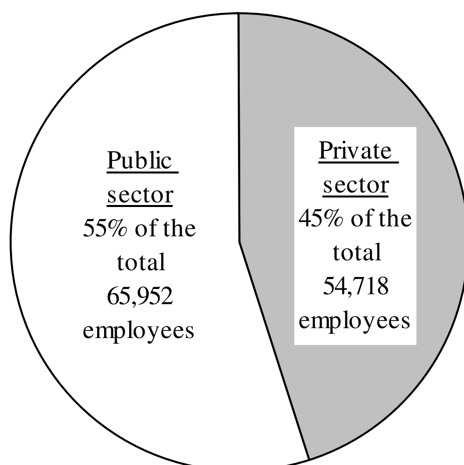
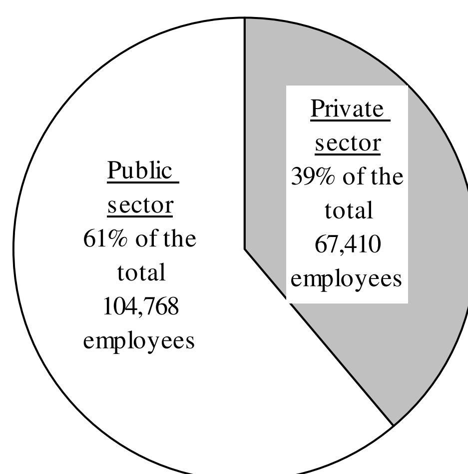


Exhibit 10b: **West Midlands**
Employment growth by sector 1998-2007
Total increase in employment: 172,178



Source: Nomis (from the Annual Business Inquiry), ONS

But, in this case, what finance gave in the decade before 2007 it will take away in the decade after 2007. The subvention of banking and anti-recessionary measures have wrecked public finances and raised the UK government deficit from 3% to 13% of gross domestic product (GDP) which, for Tories or Labour, means sustained expenditure and employment cuts in the public sector and excruciating problems in all the ex-industrial regions. This raises one major question: where are the jobs going to come from in the next ten years in outer Britain where state and para-state employment has so far covered the atrophy of the private sector?

This kind of political arithmetic about the finance sector cannot and does not generate a definitive bottom line. Our argument and empirics above do not present a comprehensive account of outcomes and consequences and we should of course remember that retail banking is a worthy utility which provides essential services for all households and small and medium enterprises, and consequently usefully distributes employment around the country. But when the finance sector adds up the social benefits of finance, it clearly does exaggerate the social value of wholesale finance which is a pro-cyclical activity with limited employment benefits, and which has the proven ability to disrupt the whole economy at vast cost to the taxpayer. After discarding the finance sector's self justifying narrative about social purpose, the more interesting question is: just what was finance doing in the boom before 2007?

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4. Banking for itself: the great transaction generating machine

If we put aside, the self justifying coalition narratives about the social benefits of finance, there are interesting questions about the economic role and function of banking in our kind of capitalist economy. Mainstream finance has always puzzled about why capitalist economies have (intermediary) banks and banking if markets are efficient. The established orthodox answer is that banks exist because they fulfil a useful role for non-bank actors by resolving some kind of informational problem.

There are different views on defining this useful role. The traditional emphasis was on the role of banks as intermediaries in the relationship between saving households and investing firms. After the rise of proprietary trading in wholesale banking, more recent academic work has argued that the role of banks is to manage and transform risk for an outside corporate customer. Thus, Allen and

Santomero (1998, p.1462), argue that the intermediary role is now being played out in the wholesale markets as banks “are facilitators of risk transfer and deal with the increasingly complex maze of financial instruments and markets”.

After the current financial crisis, it is now possible to present a different view where the emphasis is on banking for itself. Twenty years of innovation in wholesale finance did very little for anybody outside finance, except for those who wanted to trade assets and through luck or judgement took their money off the table before the asset price bubble popped. In this section of our report we present empirics and argument which explains how wholesale and retail banking are fused together as a giant transaction generating machine with mass marketing of retail products providing the feedstock for proprietary trading in wholesale.

The idea of finance working for itself is not new. “Where are the customers’ yachts” was the title of Fred Schwed’s (1940) book attacking Wall Street: The new problem is that self serving behaviour is now institutionally embedded through the doctrine of shareholder value. The new banking business models of mass marketing and prop trading were empowered because they allowed banking to deliver huge amounts of unsustainable shareholder value. This meant endless pressure for the mass of white collar bankers in high street branches and fat bonuses for an elite few investment bankers in the City who were effectively in a profit sharing joint venture with the shareholders.

This section describes the pathology of banking for shareholder value. Our evidence is all drawn from the pre-crisis period but the really chilling point is that all the drivers and structures which created the crisis are unreformed and still in place.

4.1 Banking delivers shareholder value

The precondition of banking for itself was the stock market’s demand for shareholder value. The ideology of shareholder value made no distinction between companies and sectors because all should deliver value or leave the stock market (as British manufacturing did). There never was any discussion of whether banking was an activity fundamentally unsuited to delivering shareholder value because the basic activity characteristics of banking after the early 1990 were high fixed costs, intensifying competition and secular low interest rates which destroyed the margins in traditional intermediation.

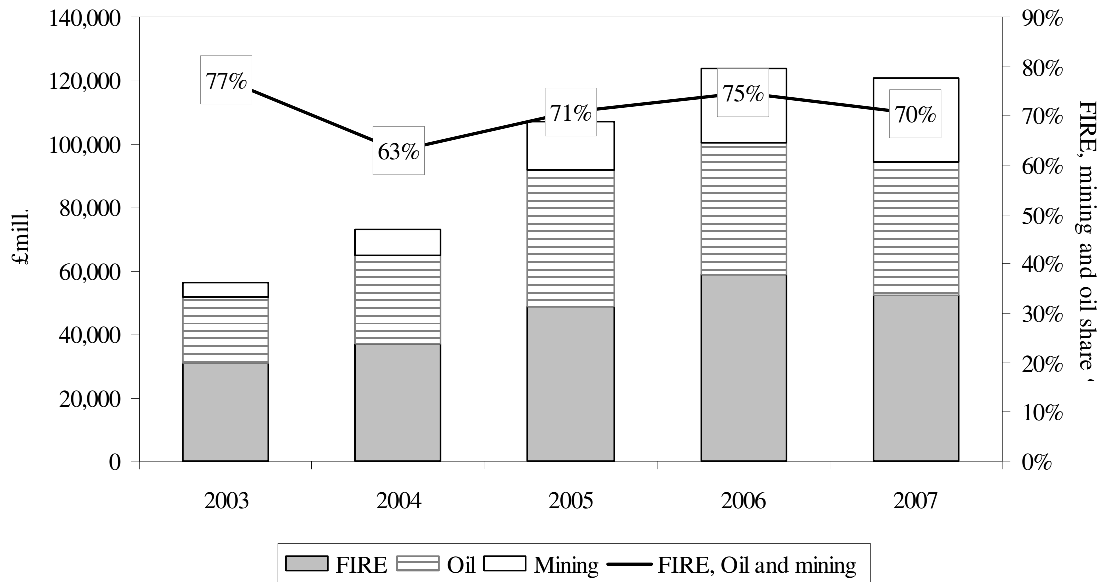
Pressure for shareholder value intensified in the bubble before 2007. Analysts and journalists constantly disparaged conservative retail banks like LloydsTSB and praising their innovative, profitable counterparts like Northern Rock which used securitisation to grow mortgage lending on a low cost base; in the same way, the more innovative firms preened themselves on how they delivered profits and share price increases. Right up to the crash, media and analyst coverage of Northern Rock was overwhelmingly positive in a way which is both comic and raises all kinds of serious questions. As the Dresdner analyst commented in 2006, just a year before the crash, "Northern Rock remains uniquely positioned to benefit from sustained mortgage growth" (FT, 26th June 2006).

Shareholder value had brought proceduralised corporate governance in its wake. But this provided no check on banking excess because governance has always been more effective as an accelerator than as brake. In general, a dearth of profits strengthens the scepticism of non-executive directors (NEDs) and the activism of outside shareholders; while an abundance of profits sedates the critical faculties of outsiders and becomes a matter of public celebration. Just like the NEDs of Enron, the non-executive directors on the boards of US investment banks like Lehman or converted former UK building societies like Northern Rock did not question business models which appeared to be working.

Shareholder value has had many disappointments in sectors like car assembly which cannot deliver because the activity characteristics and product market competition frustrate the delivery of value except through brief rallies which everybody understands are cyclical. The corporate story of banks in the bubble is rather different because banks used a variety of dodgy business models to deliver large amounts of unsustainable shareholder value for several years in the banking bubble. Converted building societies like Northern Rock and Bradford and Bingley, became wannabe shareholder value creators who delivered for a while through over reliance on wholesale funding (or reckless lending on commercial property as in the case of HBOS). US investment banks like Goldman Sachs or Lehman just went further into prop trading with leverage after borrowing funds equal to thirty times equity.

While the bubble lasted, banking delivered a spectacular (albeit unsustainable) growth of profits which ensured that financial services share of profits in the UK was temporarily larger than its 8 per cent share of GDP. As exhibit 11 shows, in the five years before 2007, the performance of the FTSE 100 was completely dominated by the commodities boom and the finance bubble. In these years, companies from oil and mining and companies from finance, insurance and real estate (FIRE) together accounted for more than 70% of total FTSE 100 profits. The "finance, insurance and real estate" category is dominated by finance, which on average accounts for more than 30% of all FTSE 100 profits over the bubble years.

Exhibit 11: **FIRE, oil and mining share of FTSE 100 pre-tax profit**
(Nominal money values)



Source: Datastream and annual report and accounts

4.2 Generating transactions: bank borrowing and lending

If we look behind the delivery of shareholder value and ask how did the banks deliver (unsustainably) when many other sectors could not, the answer is by developing banking for itself as the great transaction generating machine. The transaction generating machine can be analysed at several different levels. We will first describe it at a sectoral level using aggregate statistics on bank borrowing and lending. We will then turn to consider separately what transaction generation meant in wholesale banking, which faces the financial markets, and retail banking which deals with household customers.

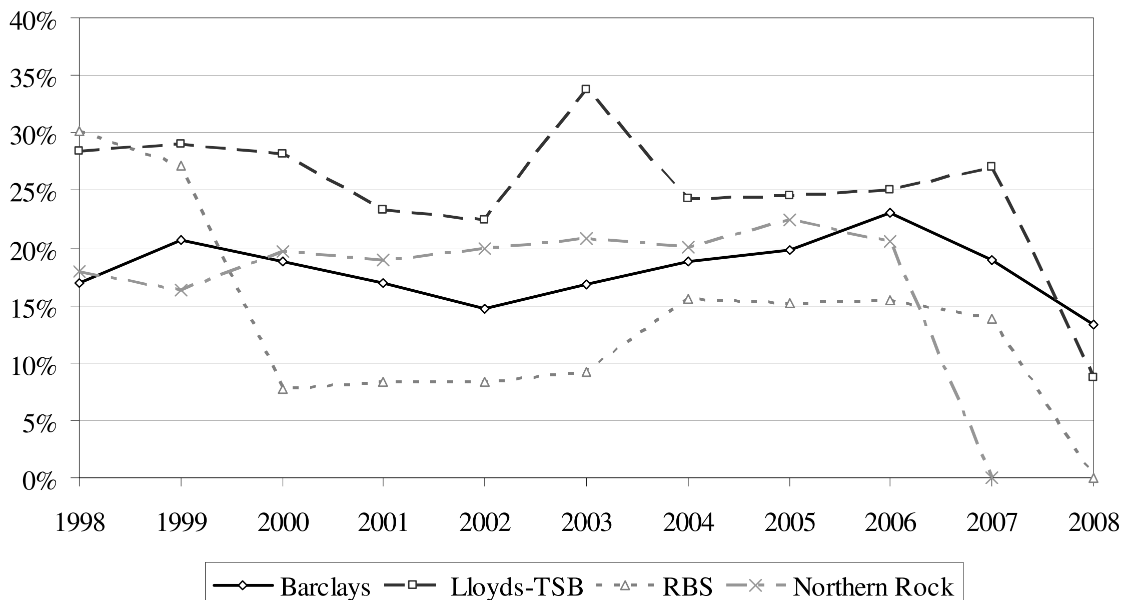
At the sectoral level, the transaction generating machine manifested itself in ballooning bank balance sheets because the transactions required both lending and borrowing which showed up as more assets and more liabilities. The answer to how the banks delivered shareholder value unsustainably is then a double one because the banking sector became an engine of borrowing and of lending (increasingly in a circular way to the financial system).

In terms of borrowing, the banking sector added leverage by borrowing more. The equity capital base remained the same, so that the banks could maintain return on equity (ROE) which was what mattered to shareholders. Increased borrowing gave the banking sector a larger asset base and depressed the return on assets (ROA) which nobody noticed until after the crash.

In an important recent paper, Andrew Haldane (2009a) has argued that the banks had no choice about adding leverage because competition "simultaneously drove down returns on assets and drove up target returns on equity". We would add the qualification that the fundamental driver was not product market competition but capital market competition which set the ROE target. When other banks wanted to lend, it was easy to borrow more to finance activities like upscaled wholesale trading which delivered more profit for the shareholders. Thus, the Wall Street investment banks before the crash were 20-30 times leveraged and looked more like hedge funds than banks.

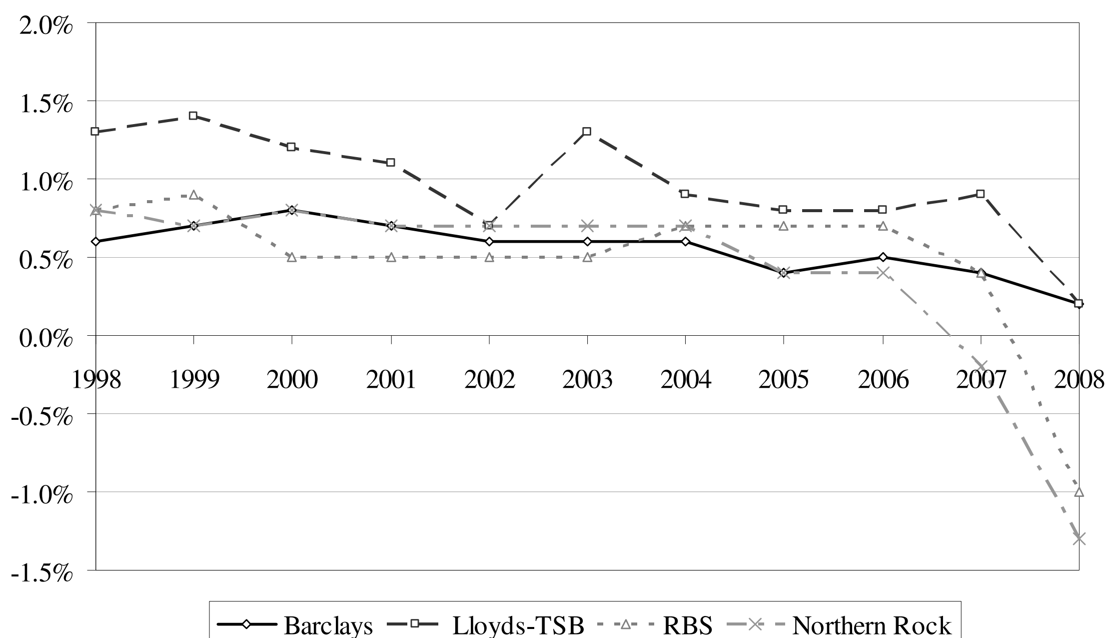
Exhibits 12 and 12a present a calculation of return on equity (ROE) and return on assets (ROA) over the decade 1998-2008 for four British banks (Barclays, Lloyds, Northern Rock and Royal Bank of Scotland). In general these banks maintained their ROEs in a range of 15-25% with no sign of secular decline; by way of contrast, ROA was already wafer thin at 0.9% for the four banks in 1998 and had declined to an average of 0.6% by 2006. The calculation also illustrates how, in a shareholder value environment, Royal Bank of Scotland was under pressure to go for serial acquisition and cost cutting as a way of covering its laggard performance on ROE.

Exhibit 12: **Return on equity for selected UK banks**
(Negative return set to zero)



Source: Thomson One Banker

Exhibit 12a: **Return on assets for selected UK banks**



Source: Thomson One Banker

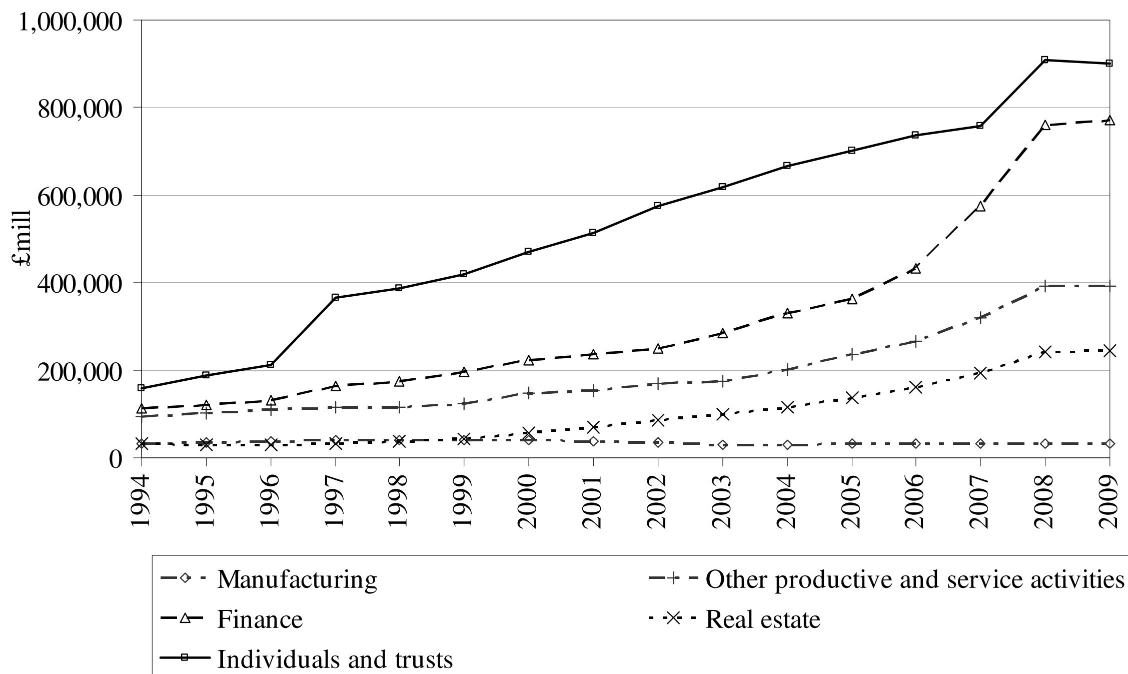
In terms of lending, the banking sector made easy loans for non-productive purposes. The loans were on property (residential and commercial) or to other financial firms because property and finance were the only sectors which had an insatiable demand for loans. These loans apparently offered attractive profitability and security for the banks which lent until the bubble burst, borrowers defaulted and markets froze.

There never was a bubble economy but there were bubble sectors in the run up to 2007. Across most private sectors of the economy, investment is funded from cash flow and there is little demand for bank loans except to fund working capital. Hence increased bank lending went to the property sector and other financial firms whose demands were fuelled by booming asset prices and buoyant profits which offered bank lenders the appearance of security. The UK's bubble was mixed up with wholesale trading and other lending to financial actors like private equity; but the Irish case shows that lending on property alone can generate a massive bubble.

Exhibit 13 on bank and building society lending to UK residents presents a longer-term view of UK lending trends back to the mid 1990s. The nominal amount lent to a low demand sector like manufacturing remains constant from the mid 1990s to 2007, while manufacturing's share of all bank loans declines precipitously from 7.9% to 1.6%. There are parallel but less pronounced declines in the share of total loans going to agriculture, construction, hotels, retail and distribution. By way of contrast, there are at least five fold increases in the nominal amounts lent to financial intermediaries and insurance funds, to real estate or commercial property and to private individuals whose borrowing demand is dominated by mortgages on residential property.

Behind these growing categories of business are the two sectors with a voracious demand for bank loans. By the end of the bubble in 2007 around 40% or more of all bank and building society lending is on residential or commercial property; and this constitutes a standing invitation for commercial developers and ordinary householders to trade assets and turn a profit through another transaction which allows a bank to make a secured loan which can now be sold on with securitization so the bank can lend again. After property is accounted for, nearly half of the rest of bank lending is accounted for by the 25% of all bank lending going to financial intermediaries at the height of the bubble because asset trading and selling on requires a capitalbases. The most rapidly growing new demand for bank loans in the 2000s came from the financial sector which (as we have seen) was adding leverage. Ironically, the total £1,200 billion cost of the UK banking bail out after the crisis (including all liabilities and contingent guarantees) was no more than 75% of what UK banks lent to the finance sector before the crisis.

Exhibit 13: **UK bank and building society loans to UK residents and businesses**



Source: Bank of England

While the unsustainable production of shareholder value continued, there was euphoria amongst bank shareholders, who received dividends, and bank customers who were offered easy loans. But there was also cause for concern because the pursuit of shareholder value intricated shareholders in dysfunctional joint venture relations in wholesale and intensified frustrations for retail customers. We will separately consider how shareholder value promoted one set of dysfunctional relations in investment banks which built up prop trading with borrowed funds as their major new profit source; and another set of dysfunctional relations in retail banking where "selling to" consumers became ever more important. At this point we are turning away from describing transaction generation across the banking sector as a whole and turning to examine how

transaction generation was separately embedded in the business models and everyday activities of wholesale and retail.

4.3 Dysfunctional relations (a) joint venture with "talent" in wholesale

In stand alone investment banks and the wholesale divisions of conglomerates, the senior workforce was effectively in a kind of joint venture with the shareholders. This undermined the idea of the public company as an organisation where the shareholder had the residual interest. The joint venture pivoted around the comp ratio or the private expectation that compensation for employees would account for a fixed proportion of (net) revenue in wholesale banking.

The argument below is that this system of profit sharing combined with "financial innovation" to provide the senior workforce with the incentives and the technical ability to expand transactions, turnover and fees by trading in complex products like derivatives. This coincidence of motive and opportunity was entirely unprecedented because greedy senior managers in other industries have always had to press their claims on a limited turnover against other stakeholders. The result in banking was an explosive increase in the proprietary trading of complex products which incidentally and unintentionally created long chains and complex circuits which increased the fragility of the financial system and its susceptibility to massive seizure.

Exhibit 14: **Compensation ratio in investment banks**
(Employee compensation as a share of total revenues)

	Goldman Sachs	Merrill Lynch	Lehman	UBS
1999	48%	51%	51%	41%
2000	51%	52%	51%	45%
2001	49%	52%	51%	48%
2002	48%	51%	51%	49%
2003	46%	48%	50%	47%
2004	46%	48%	50%	42%
2005	46%	48%	49%	40%
2006	44%	54%	49%	46%
2007	44%	151%	49%	70%
2008	48%	-86%	n/a	201%

Source: Thomson One Banker
Notes: Total net revenue is defined as net interest income before provision for credit losses plus noninterest income. Employee compensation includes all benefits. In 2008 Merrill Lynch had negative net revenues

The existence of the comp ratio in wholesale banking can be inferred from the published accounts of the stand alone investment banks which prospered before 2007;

conglomerate accounts simply make comp ratio practices more opaque so it is not easily possible to calculate such ratios for British banks from public accounts.

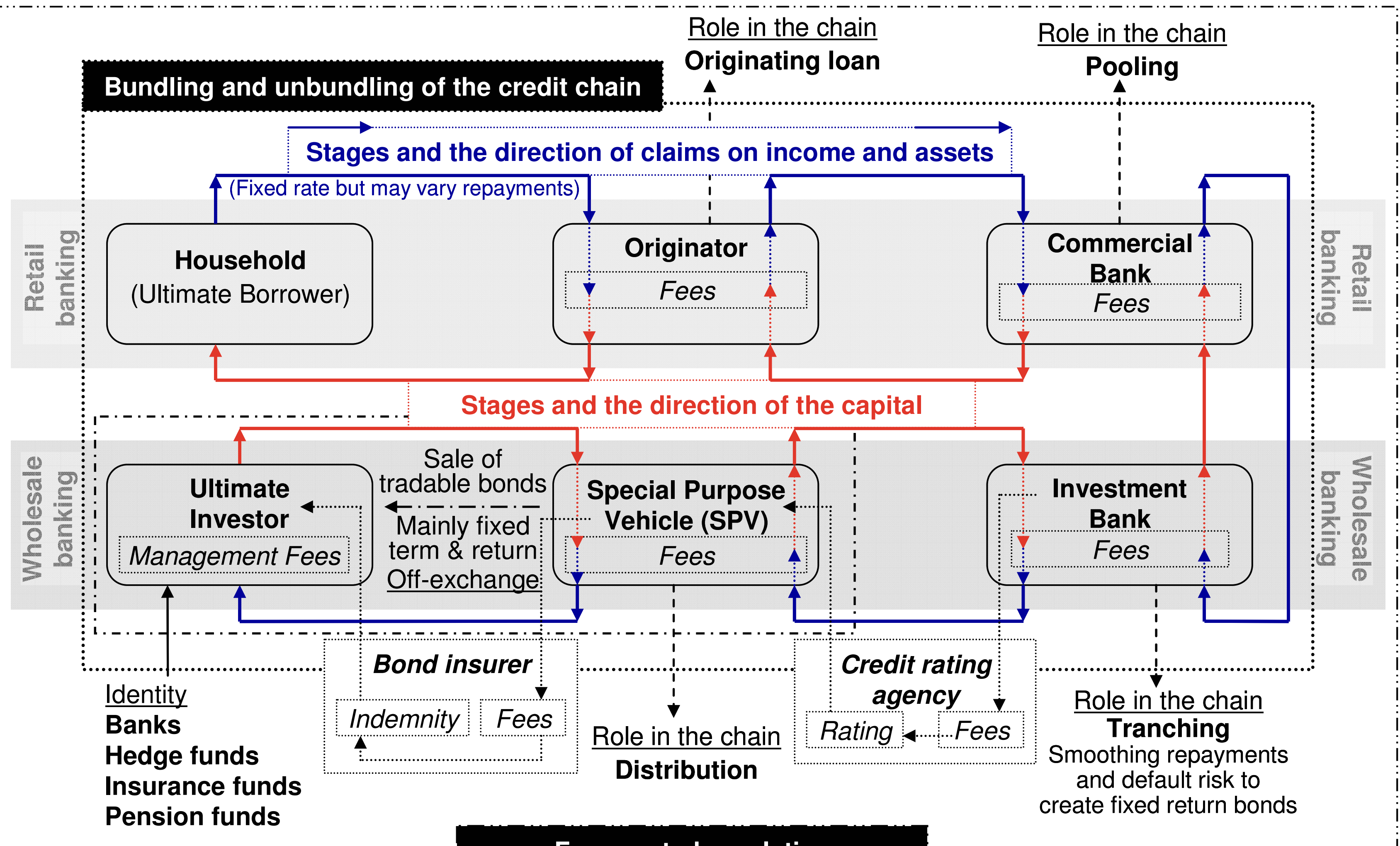
Exhibit 14 presents the results of a calculation for three Wall Street banks and one Swiss bank over a decade which covers the late 1990s boom, the difficult years after the tech stock crash and then the bubble years of the mid 2000s. The table shows that in the three US banks, the comp ratio from1999-2006 is generally in the range of 45-50% and in three Wall Street investment banks, the comp ratio varied by no more than four or five percent across the whole period. UBS shows a slightly more cyclical pattern because its comp ratio rises in bad years and falls in good years.

The comp ratio created (and presently still creates) a turnover related bonus pool which provides a direct incentive for the firm's senior wholesale employees to increase turnover from which they will collectively take a predetermined cut. At this point financial innovation becomes relevant because in the 2000s innovation facilitates the construction of chains of transactions which generate turnover. Thanks to the financial innovation of securitisation, CDOs, CDSs and all the rest, the senior wholesale workforce could slice and dice feedstock from retail loans, multiply the number of steps in the chain and build more complex circuits which at each step generated a transaction on which the bonus earning workforce would one way or another earn a clip. Long circuits were privately more profitable for the elite workforce and publicly an accident waiting to happen because long, convolute circuits are inherently and unpredictably fragile.

The result is more than enough material for a whole series of workshops and conferences. Exhibit 15 presents our visualisation of a US mortgage based transaction which creates tradable mortgage bonds and a lot of profitable complexity as default risk is turned into various forms of financial assets. Visualisation is always inadequate insofar as the material transmitted through the circuits is not some homogeneous stuff like "information"; and insofar as the asset buyers have multiple roles, as when investment banks have multiple roles as tranchers and asset buyers.

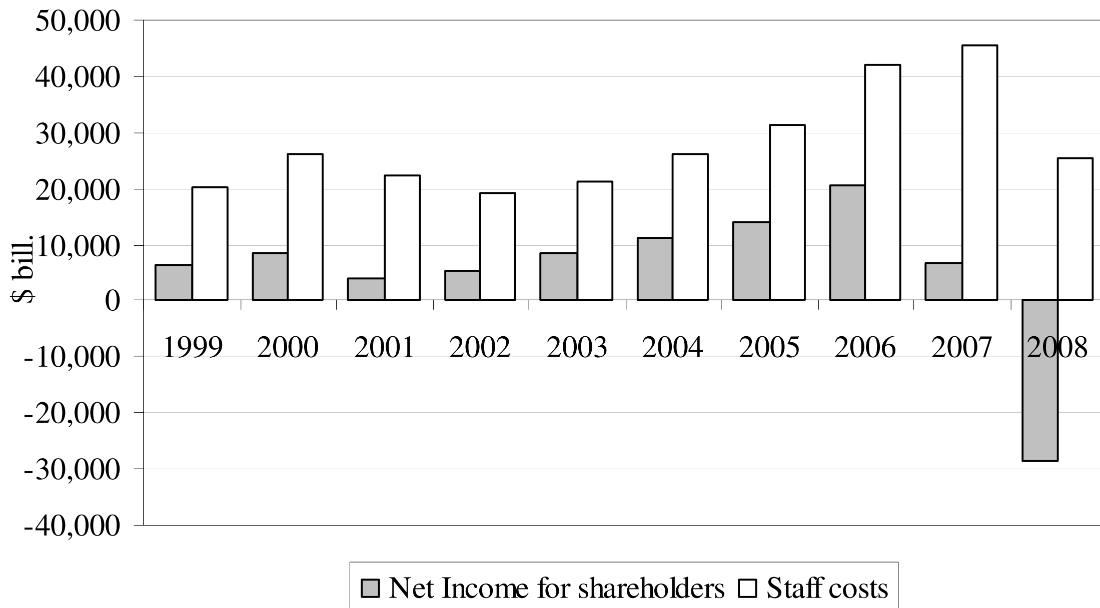
The standard pre-2007 explanation for the complexity in exhibit 15 was that the slicing and dicing created new assets with different risk profiles which both better suited buyer preferences and allowed the seller to charge a small premium. But the future income streams that accrue to such assets are fixed and none of the assets created has fixed or ascertainable risk/reward profiles. The only certainty is that the decomposition and recomposition of assets at each node creates a fee earning opportunity for bankers and facilitators like the credit raters who service transactions. Our visualisation in exhibit 15 presents an artistic truth when it shows how one retail borrowing transaction can create at least seven fee earning opportunities.

Exhibit 15: **US business model of mortgage loan origination and securitization**



The outcome of the comp ratio plus innovation is that all banks with significant wholesale activities exist for the benefit of the workforce more than for the shareholders. This much is clear from the published accounts of the Wall Street stand alone investment banks in the bubble. Exhibit 16 presents an aggregate calculation for three such banks (Goldman Sachs, Merrill Lynch and Lehman) over the decade after 1999. A comp ratio of 50% always trumps an ROE of 20% because staff costs in wholesale consistently account for more than twice the sum distributed as net income.

Exhibit 16: **Combined employee costs vs net income in Goldman Sachs, Merrill Lynch and Lehman**



Source: Thomson One Banker
Note: 2008 totals exclude Lehman

This is of course not unexpected and in many other activities the workforce takes more than shareholders. Consider, for example, a typical manufacturing company, where the purchase to sales ratio is around 50% and labour's share of net output is around 70%. In this kind of manufacturing company, the internal workforce would claim around 30% of turnover or (gross) revenue, which would ordinarily be several times larger than distributed profit. The important point however is that seldom in human history has such a small elite workforce taken such a high proportion of turnover as in wholesale banking; and never before in history has this kind of elite been able to fabricate beneficial turnover through financial innovation.

If we are contextualising the scandal of wholesale banking, we should emphasise two important differences which make labour's bonus claims in wholesale banking much more dubious than the labour wage claims of the factory worker or check out assistant. First, in manufacturing, retail and most other activities, any workforce claims on turnover are diluted by large obligations to pay outside suppliers for components or stock. In retail, for example, stock purchases would typically account for 80% of turnover or revenue and, if the workforce claims 50% of net output, the whole of a supermarket's

workforce is paid out of 10% of turnover. Second, in most other activities like manufacturing, retail, distribution and business services the activity is inherently labour intensive and requires the employment of many workers who individually must generally earn modest wages because that is the logic of many claimants on a limited fund. Thus manufacturing or retail is an engine for diffusing prosperity while wholesale banking extrudes millionaires.

4.4 Dysfunctional relations: controlling and recovering costs in retail

The problems of dysfunctional retail represent another side of shareholder value practice. Wholesale bankers in the financial markets (like corporate CEOs) were culturally defined as a "talent" that had to be rewarded so that shareholder value could be produced; whereas retail bankers in the high street branches were culturally defined as a cost that had to be reduced through branch closure or recovered through incentivised "selling to" households.

The emphasis in the 2000s was increasingly on cost recovery because the branches are expensive but necessary for the high street majors. 80% of consumers say that their preferred channel of arrangement for current accounts is a branch and company shares of the current account market are closely correlated with the extent of a particular provider's branch network (Datamonitor, 2008). Branches are also the material support of customer inertia which is such a striking feature of retail banking. Only 7% of current account customers switch in any 12 month period and 65% of consumers have held their current accounts for more than 10 years (Ipsos MORI 2008). Before or after the crisis, retail consumers mistrust banking but have more trust in their primary bank. In a 2009 survey, the average consumer rating of trust in the banking sector was 2.1 out of 5 but the average trust rating in their (current account) primary bank was 3.4 out of 5 (Datamonitor, 2009).

The branch network is then the place where the implied promise of good advice is betrayed as an adviser on incentive pay "sells to" the retail household. Thus RBS has been promoting its NatWest brand under the slogan "helpful finance". A series of TV commercials by Yipp Films uses real staff and customers to illustrate how NatWest has "money sense advisers" in more than one thousand branches. The voice over sententiously claims "they are not there to sell but to give you free impartial advice". When the consumer body *Which* sent researchers to NatWest branches, it found that only 4 out of 20 sessions offered impartial advice while 16 of 20 sessions ended in attempts to interest the consumer in NatWest products which were the only products mentioned in six sessions (Observer, 10th May 2009).

In shareholder value retail we have created an industry where senior retail managers then make matters worse by making bad decisions on customer service so as to meet targets. When the academic authors of this report met with the Unite finance section's national committee in July 2009, the unionists' complaints about retail banking were about how

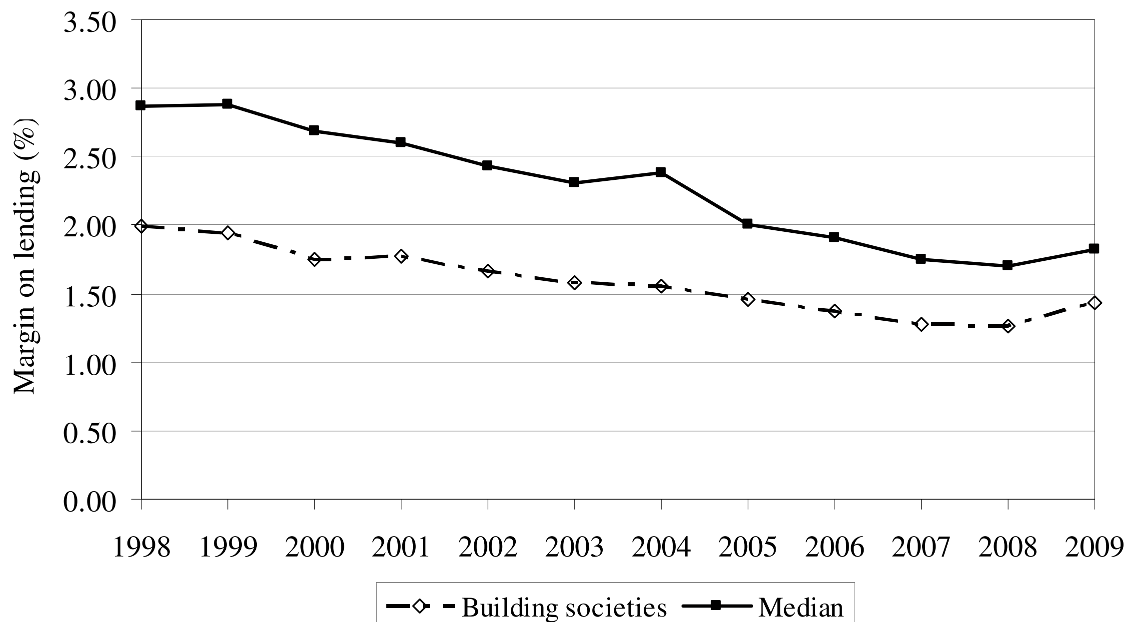
customers and workers were both being mistreated in a retail system where performance pay means incentives to sell and where, in front or back office, service without a revenue steam and cost recovery always gets cut back. In one major Northern town, a high street major bank replaced four established retail branches in and around the city centre with one prestige new branch designed to advise; the number of counter service positions was incidentally reduced from 20 to 5 positions so that customers faced long queues for teller services (meeting 1st July 2009). On the other side of the Pennines, another high street major closed a back office servicing ISAs and bonds. It sacked 200 experienced staff and saved cost by transferring the work to newly employed staff on the minimum salary for their grade, who were immediately faced with a backlog of 17,000 outstanding pieces of work (email 31st July 2009).

4.5 The unlevel playing field

Put another way, the branch system was, and is, a massive barrier to entry which protects the incumbent major PLC banks. But that has never figured in public discussion of banking which generally does not register that there is an unlevel playing field in retail which systematically disadvantages mutuals and smaller firms.

The UK has the remnants of a non-shareholder value based financial system in a mutual sector which includes one super mutual (the CFS), one big building society (Nationwide) and various tiddlers plus some significant insurance companies which survived the demutualisation of the late 1990s.

Exhibit 17: **Bank and Building Society margins**



Source: Bank of England
Note: The median is an average of all UK banks and building societies. Consequently, bank margins are higher than the median average

Most but not all behaved sensibly and conservatively in the bubble; and (in the absence of profit requirement) building societies continue to offer a better basic retail proposition than banks because, as exhibit 17 shows, they operate on a lower net interest margin.

If their margin of superiority is being eroded, that is mainly because mutuals and all smaller players are disadvantaged in a variety of ways by an unlevel playing field. Building societies were hit by credit downgrades in early 2009 after extreme stress tests by ratings agencies with something to prove. But they have long been structurally disadvantaged by higher costs of deposit insurance under the Financial Services Compensation Scheme (FSCS) charge system; and all smaller banks are handicapped because they must buy clearing services from an existing clearing bank which will make a profit by offering this facility.

After the crisis, there has been a flurry of interest in encouraging new entrants to banking. But the government appears lukewarm about the proposals for a Post Office bank which would have 11,500 branches. The field is therefore open for Tesco, which has the branches and the ambition to do for banking what it did for petrol retailing as well as the capabilities to increase cross-selling which is one of the major problems in the current system.

The prospects in wholesale and retail are thoroughly dispiriting because few of the underlying problems have been identified in public debate and none of them have been addressed. So what are the immediate policy implications of our analysis of banking: what would a radical set of democratic demands look like?

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5. Next steps and resistance to reforming wholesale and retail

If reform proposals had lost impetus by summer 2009, it was partly because the task was technically difficult and had failed to generate any political traction. Partly this was because the reform options were so bewilderingly diverse. The menu of choices for "safer finance" included: structurally separating retail and wholesale; inventing a new practice of macro prudential regulation; varying old regulatory requirements by way of capital adequacy, counterparties and governance; and/or experimenting with new instruments like living wills or Tobin tax.

If the choices are specified this way, the ultimate failure of reform is then inscribed in an entirely predictable balance of political forces. Elites resistance to reforms that would crimp money making is much stronger and more effective than

mass pressure for technical reforms that would make finance safer. Most of the proposed technical reforms are being effectively resisted or diluted by the lobbyists of the distributive coalition. Mass political support is weak because the technicalities of capital adequacy ratios and such like are unintelligible to the mass electorate who are indignant about extravagant bonuses which the politicians apparently cannot stop.

Hence, our approach is rather different. We do not pretend to know what mix of policies would deliver the outcome of safer finance but we can recommend a mix of policies which would deliver a more socially responsible finance and help to de-risk the system. Building on the analysis in the last section of this report, from the average household's point of view the effective re-regulation of retail banking is probably just as important as de-risking wholesale banking. While wholesale can then be reined back in new and imaginative ways by encouraging the shrinkage of wholesale, setting demanding social reparations from the comp ratio and so forth.

Politics is not only the obstacle to reform but it is the medium through which reform can be won. Most of what needs to be done could be technically achieved through a large hike in capital adequacy ratios but politically that is never going to happen. So let us pursue alternative policies which will take us in the right direction of travel because the policies can be made politically intelligible and actionable.

As General Booth observed in a different context, "why should the devil have all the best tunes?". Let us learn the lessons of the historical success of the distributive coalition which has got where it is today by telling an intelligible and actionable story. Radicals need to construct the reform agenda as a sober, intelligible story which the electorate, minority parties and NGOs can all borrow and embroider. This section starts to raise questions about political strategy and how the limits of the possible can be shifted; these questions are taken further in the sixth and final section of this report.

5.1 Wholesale (a) reparation and simplification

Most current discussions of wholesale reform begin or end by presenting a choice from a menu of technical policy instruments for safer finance. Our evidence and argument so far about the uselessness of finance and its business models suggests a different starting point. If dysfunctional finance has imposed huge costs on economy and society, we

should begin by considering the scope for compensating society with more than the standard tax yield from financial services.

The form of reparations does of course need to be carefully considered so as to avoid the risk of encouraging even more pathological risk taking behaviour over the next cycle. From this point of view, we favour not the anti-capital measure of a levy on banking profits in wholesale and retail but the anti-elite labour measure of top slicing the lump of revenue now allocated to the elite workforce under the comp ratio system. The proposal would be to top slice by say 25% in all wholesale banking operations. This has the merit of being simple because the comp ratio could be assumed to be 50% of net turnover unless proven other wise by bank calculation. It would also be indirectly beneficial because it would significantly reduce the size of the total bonus pool available for distribution and weaken the dynamics of the pernicious elite and shareholders joint venture system in wholesale finance.

We do not believe that banking can be effectively reformed by more active remuneration committees and chief risk officers fiddling with the details of how bonuses are distributed or withheld; and, specifically, we do not therefore favour capping maximum bonus, withholding bonuses for three years, paying bonuses in stock which must be held or clawing back bonuses after trading losses are incurred. Claw back provisions may have some symbolic value. Such proposals rest on the fundamental misapprehension that traders at a node in a complex circuit can calculate the risks of what they do. From our point of view, this kind of calculation of risk incurred is usually irrelevant and impossible in a system which is smart at the links and dumb through the chains.

But some reduction in the bonus pool would be politically popular and economically sensible, more especially because the bonuses are now being earned in banking firms which are either government owned or benefit from government guarantees after costly system bail out.

The question of de-risking the finance sector then needs to be addressed separately after recognising that finance is increasingly an opaque matter for insiders with central bank and regulatory technical experts struggling reactively to understand the latest innovation which will usually be an object of world class lobbying for bonus driven financial elites with access to the best transaction generating innovations that quants can devise.

Many of the official reports into the crisis recommend generally higher capital adequacy ratios but we doubt very much whether UK or USA regulators will be empowered to set these ratios at levels which seriously reduce profitability and penalise large, complex financial institutions. Furthermore, there are considerable difficulties about imposing effective regulation on hedge funds, private equity and all the other users of leverage. These funds could, and maybe would have blown up the financial system within eighteen months of summer 2007. Now they argue to be excused from re-regulation because they have no direct responsibility for the present crisis.

Against this background, we have to start from activity basics and a presumption in favour of simplification. Financial innovation is mutable: if it was over-the-counter (OTC) derivatives last time, it could be Islamic bonds or carbon trading coupons next time. But the recurrent technical problem is that financial innovation is improvised *bricolage* which creates long fragile, interconnected circuits which loop round within the major financial centres and lead who knows where outside the centres. The object therefore should be to simplify wholesale finance and the question is what regulations and instruments will encourage short, direct chains where the location of risk and the identity of the holder is much more knowable; just as risk on wholesale transactions can be otherwise reduced, by limiting leverage, imposing margin requirements or insisting on counterparties.

From this point of view, a Tobin tax, as originally proposed by James Tobin, to put sand into the transaction machine is well worth considering. In advocating this measure, we should challenge the standard argument that an effective Tobin tax would increase "the costs of borrowing". Look back at the visualisation in exhibit 15, to see how financial innovation generates its own transaction costs by multiplying the number of steps at which fees are charged. Shorter, simpler chains reduce elite deductions.

5.2 Wholesale (b) shrinking the sector

Because wholesale banking creates complex activities within often opaque PLC business models, the project of de-risking through simplification of finance has an uncertain outcome. So, activity simplification policies need to be backed up by sector shrinkage policies which encourage no growth or a smaller wholesale sector. Because, other things being equal, a smaller (simpler) wholesale sector imposes fewer risks and costs when things go wrong and it is not difficult to engineer a smaller sector with "no favours" fiscal policies and deliberate restriction of feedstock:

"No favours" means exactly that for funds and individuals in the finance sector because national considerations should come first in determining tax policies.

Wholesale activity is not so valuable that it justifies concessions about low effective tax rates, offshore location and no disclosure which alternative investment funds, for example, have all used and now seek to maintain. Personal income tax and capital gains rates should not be reduced or maintained low simply in the interests of maintaining London's competitiveness as an international financial centre; large concessions to "non doms" and easy access to this status should be decided from a national point of view.

City threats to leave should be identified as part of a global game of arbitrage about regulation and tax regimes which will have dangerous consequences if, for example, middle income groups adopt the tax avoiding attitude of senior bankers.

Moderating the national supply of feedstock from retail savers and their funds is the other important consideration because finance is a very peculiar sector where retail feeds wholesale (rather than the other way around).

This does not mean Luddism about securitisation of loans –an entirely acceptable practice as long as transaction chains are short and transparent. But this policy stance does mean reversing the bias of the Bischoff Report which argued that the financial sector can provide new products that meet social needs (like care in old age); or the technocratic vision of an academic like Shiller who envisages a huge extension of option based insurance. The Bischoff bias would route household savings and loans through the wholesale markets, greatly increasing feedstock, and provide new opportunities for boosting turnover by churning coupons on which wholesale traders earn a clip.

Our default alternative would be to favour bypassing the markets and using public sector alternatives. Faced with the requirement for higher tuition fees in universities, we favour the NUS proposal for a graduate tax via the Treasury rather than the CBI and University Vice-Chancellor's proposal for student loans raised via the wholesale markets. In funded saving, some simple variant on deposit savings accounts or bond investment would suit many retail customers and cut out the wholesale middlemen.

5.3 Retail: a new kind of regulator

Effective retail regulation needs to target the behaviours and business models of retail service providers (while incidentally redirecting the efforts of consumer education away from literacy and towards prudence). The starting point has to be that retail banking is a utility because households and firms must have access to reasonable payment services, deposit facilities, and savings and loans which are as socially and economically necessary as electricity supply or telephony.

In most utilities there is a generic bargaining power problem because smaller retail users of electricity or telephony do not have the clout to extract security of supply at a reasonable price (as larger wholesale customers may be able to do); and the essential nature of the utility service is such that the supplier must be put under a reasonable obligation to supply electricity or water to remote customers and to maintain supplies (e.g. by card meter) to those with bad payment records.

The technocratic Thatcherite solution for these problems in privatised utilities was not governance but a regulator with responsibility for low prices and fair services, and there is much to be said for appropriating this administrative device and using it for altogether more radical, democratic purposes in banking. The regulator should be advised by a broadly based retail banking committee and the regulator's brief should include extending the range of advice available in high street bank branches and changing the banking business model not simply delivering low prices.

The Thatcherite prototype of a regulator is a former university professor or civil servant advised by micro economists. The origins of the regulator matter much less if the individual regulator is advised by a broadly based retail banking policy committee.

On this committee, representatives of consumer organisations, SME business and the organised retail workforce as well as NGOs, churches and others who have alternative views of credit in society, should complement expert economic representation. Giant firm and trade association representation on such committees would be conditional upon explicit, public understandings that the trade accepted limits on its currently preferred tactics of insider lobbying.

The Thatcherite brief is that the regulator should deliver low prices and ensure supply. There is much work to be done in ensuring supply both in terms of branch provision and insistence that all banks take their share of basic bank account applications. But, while credit card interest rates need to be reviewed and probably capped, low prices for all banking services are not an end in themselves because prices need to be considered in the context of the banking business model.

For example, charges for current account provision may need to be re-introduced insofar as free current account banking currently increases the pressures for cross-selling. Certainly, more transparency and less confusion pricing is required.

Finally, a new regulatory regime would try to work out how to build on the competences and motivations of the retail workforce, specifically by outlawing commission and bonus based pay for performance. Retail advisers should be rewarded for acquiring the knowledge and interpersonal skills to inquire into customer circumstances and not sell where a product is inappropriate. This requires a new approach to explaining the limits and costs of products as well as standard industry techniques like credit scoring.

This approach is necessary because of the special characteristics of retail banking as a utility which offers complex products that often represent major, long-term commitments and hard to reverse choices. Individual households can, for example, in other utility purchases easily learn from mistakes and switch their electricity or telecoms supplier; but this is impossible or difficult with pension plans and such like. Retail banking also offers welfare critical products which can be dangerous or ineffective: revolving loans on plastic cards that consumers cannot repay or savings and pension plans that deliver little retirement income are not like a mobile phone device that does not work reliably.

Over time the aim here should be to introduce the kinds of safeguards about efficacy and availability which we take for granted in ethical pharmaceuticals.

5.4 Opportunity for a different kind of privatisation

At the same time, the aim should be to limit the operation of the shareholder value driver through new policies. The *de facto* nationalisation of banks in the UK is a huge opportunity for imaginative measures which could reduce the scope of shareholder value; although these will be unacceptable to the state holding company UKFI as long as it is staffed with a cadre of ex-bankers as execs and non-execs.

Of course, the banks like RBS and Northern Rock have to go back into some kind of majority private ownership eventually and the minority stake in Lloyds/HBOS has to be run down. But these companies do not have to go back onto the stock market and into the FTSE 100 index because they could be floated through *bond (not equity) sales* so that the obligation to deliver ever more earnings and boost share prices was removed.

It is wrong to consider the reflotation of the state owned banks as just another private equity transaction where the aim is to book the largest profit at the point of sale. Long term value for the taxpayer depends on finding some balance between raising revenue from stock or bonds at point of sale and changing ownership forms and business models so that retail finance is both more socially responsible and safer going forward.

At the same time, the playing field in terms of infrastructure charges and such like should be levelled to ensure that mutuals can compete fairly and expand their operations; any substantial expansion of the mutuals would probably also require various kinds of bond financing so that the line of distinction between mutuals and bond based banks would become increasingly blurred. In all this, it should also be remembered that simple mutuals could behave imprudently. Therefore they would need close supervision and regulation.

5.5 Political resistance from the distributive coalition

The proposed change of policy stance in wholesale and the effective regulation of retail would be violently resisted by the distributional coalition around finance and its political hostages. Radicals therefore need not only a set of policy demands but also a political strategy for dealing with the structural problem of centralised political power in the UK and the cultural problem of Stockholm syndrome in the political classes in both major parties. Realistically, this should involve pessimism of the intellect about the limited prospects for early, effective reform of wholesale finance (though we can frame demands more intelligently) and optimism of the will about the scope for pressuring reform of retail through a new kind of politics.

On wholesale finance, even before contesting the 2010 election, David Cameron and George Osborne (just like Gordon Brown and Alastair Darling) will have been lobbied to the point where they understand the wisdom of not interfering too much with the game of

City money making. Post-victory, a cynic would add that after presiding over public expenditure cuts, the Tories can only hope to pull back some political popularity if they license an unregulated credit boom in the mid 2010s as they did in the later 1980s.

But no government can say it is against better consumer protection in retail finance. Hence the importance of putting together a new kind of politics which would start in the parliamentary sphere by asking for a post-Thatcherite regulator of retail banking and a new and effective Banking Select Committee. The double aim should be greater elite accountability and much more information and debate about what utility banking is doing and should do for SMEs and households.

We would also be hopeful about applying extra parliamentary pressure in imaginative ways because the high street banks are vulnerable in the early 2010s at the point of brand and reputation; just as the pharma companies were in the late 1990s when Oxfam and Médecins sans Frontières went onto the attack about aids and drug prices in sub-Saharan Africa. That vulnerability is defined by the gap between retail promises about "helpful finance" and what the banks actually deliver through the branches. At this point, the retail banks have much to fear from a new plus old coalition which includes NGOs plus trade associations representing small business as well as trade unions which represent the views of the retail workforce.

If the aim is to get beyond negative restrictions on what banking can do, and to deliver something larger than consumer protection, then we need an alternative vision of what banking could and should be as a basis for political mobilization. The next section turns to develop this vision.

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6. An alternative vision? Sustainable debt and some big questions

If banking reform is going to succeed, it will only do so by building a political alliance for reform. As part of this process, immediate demands need to be formulated in a form which is politically intelligible and actionable. The result would inevitably be a rather negative politics about the masses against the bankers. But the political impetus for reform also depends more fundamentally on the capacity of radicals to generate a positive mobilising vision of what a different kind of finance should and could do to address our fundamental problems.

If the critics of banking have yet to develop their vision, the distributive coalition around wholesale has already articulated its vision of what finance could do. In the Bischoff report and elsewhere, their vision is of a future where innovative new

financial products meet every social need, like those in old age. The problem here is not innovation *per se*, but the prospect of bank led *bricolage* in a much larger and substantially unreformed wholesale sector. On past form, social needs would not be met and the risks of economic instability would be hugely increased.

It is difficult to develop a radical alternative vision of what finance could and should do. It requires some fundamental thought about the nature of credit and debt, their function in financialized capitalism and their role in the present conjuncture in the UK. These issues have not been dealt with in public discussion since Major Douglas and Frederick Soddy raised them in inter-war debates, when questions about capitalist credit and debt were mixed up with essentialist claims and metaphysics about the sources of wealth and value which we could not now take seriously.

In this section we take up this task by presenting argument and empirics about the circuits of credit and debt. The problem of 2007 was not too much debt but the wrong kind of debt. Too little credit went into generating sustainable claims on more resources and too much went into circuits predicated on asset price inflation which was unsustainable. Empirically, we demonstrate that in the UK before 2007, credit was very cheap and everybody was over borrowing except non-financial companies who drew very little credit for any useful productive end.

The rest of our argument is set in the context of the current conjuncture. It identifies some inescapably big questions. Where will the jobs come from now that the British state can no longer afford Keynesian reflation? How do we build a sustainable politics of inter-generational transfers? Our answers highlight the need for a shift in the private sector savings and investment paradigm towards sustainability through high investment and low returns.

6.1 The distributive coalition's vision

The distributive coalition is quite unabashed by the current crisis of financial innovation and its historic failure to generate social protection through funded saving and insurance. Indeed, the coalition now seeks to pre-empt the future by envisioning a future where finance will play a much larger role in everyday life. Hence the Bischoff Report borrows the language of third sector social innovation and then argues that "society continues to face significant unmet needs which we believe are likely to remain unresolved without significant and continuing development of new financial products and markets" (Bischoff, 2009, p.45). These markets could meet every need from start up projects to

national debt finance, through retirement and health care provision to infrastructure and Islamic finance.

The subsequent Moss Report, co-sponsored once again by the Treasury and the distributive coalition, represented in this case by the Insurance Industry Working Group, reinforced Bischoff's message. This reworked an old line about how more of the same private sector provision could solve the problems of inadequate saving for retirement. As the FT noted (27th July 2009), the Moss Report also added a new promise: that private insurers could "help relieve the burden of welfare provision from the public purse" (newly emptied by the demands of bank bail-outs). Andrew Moss is chief executive of Aviva PLC which has recently announced plans to enter the rented sector and "create an asset class out of rented homes in the UK" (FT 26th July 2009).

If this vision was realised, more would be routed through the wholesale markets so that the turnover and clip available to wholesale finance would be greatly increased. This would not necessarily solve problems of social protection and at the same time would considerably increase the risk of unmanageable economic instability. If the size and complexity of wholesale markets greatly increased in a centre like London, a large high income country like the UK could easily find itself in the predicament of small countries like Iceland or Ireland. Here banking grew so large in relation to the rest of the economy that the ensuing bust was technically unmanageable; or in the Irish case, only politically manageable by the destruction of valuable social partnership institutions and compromises.

The direct response should be to just say no to expansion of the financial markets. The difficulty is to make that refusal stick through negative warnings unless we have an alternative positive vision of what finance could and should do. It is intellectually difficult to develop that alternative vision when fundamental discussion of credit and debt vanished with the rise of Keynesianism. This fed off Keynes's achievement in proposing a General Theory of 1936 which could pass as, or be assimilated into, the dominant economics paradigm. Hence Keynes in 1936 ignored J.A. Hobson and dealt with Major Douglas in an appendix. It is time to resume discussion of fundamentals.

6.2 The circuits between credit and debt

Since 2007 many have said that we have too much debt, but that observation is not very helpful because the key questions concern not the amount of debt but the sustainability of the circuits between debt and credit. Debt is not a problem when put to productive use to create credit which facilitates physical investment and material transformation via infrastructure, care services or manufacturing as the basis for economic advancement and social improvement.

The connection to sustainable growth is crucial because all debt is effectively a claim on the economy's ability to generate resources in the future and the right kind of debt is both

proportionate and (via credit funded material investment) resource increasing. Sustainability is about establishing a virtuous stable circuit between debt and the trajectory of the economy going forward, which is underwritten by public and private investment in people, machines and infrastructure combined in material transformations with physical and financial returns (improved productivity, increased employment, profits and lower carbon foot print).

Our central perception is that, if all debt is a claim on future resources, the sustainability of debt is linked to the amount of resources that an economy can create, and this resource quantum depends partly on how credit is applied. From this point of view, the financial crisis of 2007 was also a crisis of the "real economy" because on the one hand the markets were unable to sustain the belief that debt would not be repudiated at some point in the future and on the other hand the real economy was increasingly unable to generate the resource growth required to pay down liabilities (on rising asset prices).

The circuits between financial markets and the rest of the economy and questions of material transformation have been neglected in discussions of the post-2007 crisis where too much attention has focused on the role of psychology, behaviour and belief inside the financial markets. The emphasis on belief is of course understandable when our kind of financialized capitalism is prone to asset price bubbles which are inflated by irrational exuberance and deflated by lack of confidence. Think only of the UK economy busts after 1989 or 2007, or the US economy after the new economy boom and the tech stock crash in 2000. Each cycle ends in a bust after pulling asset prices away from their normal reference points such as price/earnings on the stock market, yield in commercial property or affordability in housing.

The new problem of asset price bubbles has replaced the old problem of commodity price inflation which still preoccupies some central bankers. But we doubt whether the new cyclicality should now be understood in the kind of psychological frame proposed by Akerlof and Shiller. These authors use the term "animal spirits" to cover everything (from confidence to stories) which suppresses economic rationality and promotes "excesses". The phrase is taken from Keynes but Akerlof's appropriation of "animal spirits" both generalises and simplifies Keynes's original analysis which distinguished between the motives for productive investment and the dynamics of speculation in liquid financial markets. It is also possible to tell a different story about credit and debt circuits as the material context of exuberance and we will do this first by generalizing about financialized economies before considering the specifics of the British economy.

Generically in capitalist economic systems, asset price increases can be an unsustainable source of gains without material transformation because the possibility of such gains is inscribed in the dual character of capitalist assets which have both use value and exchange value. For example, the factory and its productive machines can be operated or sold on, just as the owner occupied house can be lived in or traded. But this possibility of gain is hypothetical in many kinds of capitalism because the market in assets is limited

and the practices of debt and credit provision do not encourage mass indebtedness or active asset trading. Financialized capitalism removes these inhibitions and facilitates asset trading by ordinary consumers and businesses along with old and new financial actors, from investment banks to private equity. All become increasingly preoccupied with value crystallization and extraction from asset trading rather than realizing continuous value streams from material transformation.

In stylized terms, financialization undermines the biblical injunction against neither lending nor borrowing. The banks are already in the business of lending and are attracted to lending more against assets if, as Minsky believed, bankers always like to do the easy conventional thing. What could be easier for bankers than lending against commercial or residential property which offers an apparently steady stream of returns? But then households also find it attractive to borrow to fund consumption and realise gains on house property; while businesses find it attractive to borrow to financially re-engineer the corporation for acquisition or for loading up balance sheets with debt. Old and new financiers gear up to trade in existing markets and create new markets in coupons and bundles of assets. Most assets do not change hands and many owners resist easy money, but enough assets change hands to shift reference prices which rise unsteadily. If asset prices are rising, why not buy coupons, companies or property and then make a turn by selling on with rising asset prices?

Dealing into rising asset markets makes traders look clever and everybody feel rich. It does so in what is otherwise a world of difficulty, where the returns from building and operating a business will always be uncertain and limited household earnings will always make capital gains very attractive. This will of course end badly for anyone with poor timing who does not get back to cash or holdable assets before asset prices crash; and the immediate cause of the crash will always be a psychological failure of confidence which leads to crises of illiquidity and insolvency. But the underlying and fundamental cause is the growth of financialized circuits of credit and debt which have nothing to do with material transformation. As debt accumulates without any commensurate increase in the economy's capacity to generate material resources, only increasingly unjustified confidence stands in the way of bust. The psychological factor is more symptom than cause.

6.3 The UK case: credit and unsustainable claims

If that is the general story of (mass) financialized capitalism, the UK in the 2000s or the late 1980s provides case history of how credit can lubricate everything except sustainable growth. Our analysis below shows how unregulated credit and indiscriminate lending in the 2000s ensured that funds were diverted onto the wrong objects and circulated into the wrong parts of the UK economy so that accumulating debt created longer term problems.

We have already described how the banks borrowed to trade coupons and lent to support and the results after 2000 were quite spectacular for households and (non-financial) corporations.

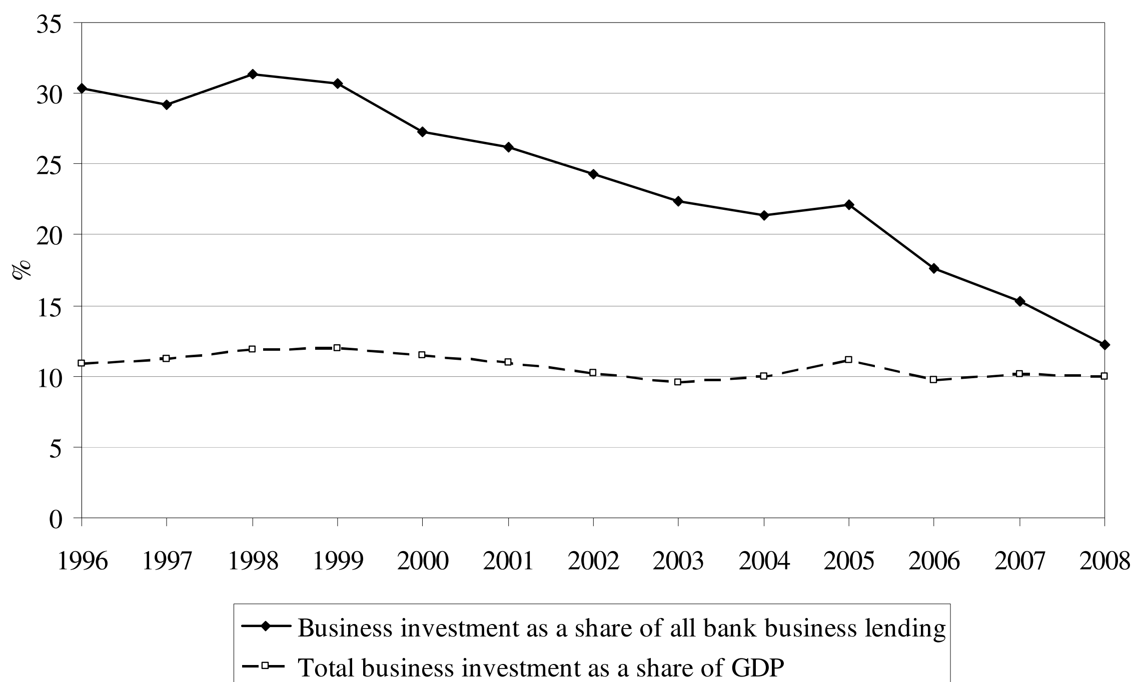
- Indiscriminate lending for consumers loaded revolving debt onto the household balance sheet and caused the housing bubble. Non-secured consumer debt more or less doubled to £4,000 per head of UK population between 2000 and 2007 and much of that went on consumption with a high import content (Erturk et al., 2008, p.10). House prices doubled in real terms which pushed up the debt burden on new entrants and low income households who spent 40% of disposable income on mortgages; for those already "on the ladder" it also produced euphoria through equity withdrawals which turned into new kitchens and German cars.

- Corporate business was re-engineered for value extraction through the institution of leveraged private equity which upscaled to the point where it threatened Sainsburys and bought Boots just before the crash. The formula was to concentrate gains for equity holders by leveraged purchase of companies; then use cashflow to pay down debt with maybe a dividend recap to recover the equity investment. The company would be sold on for a higher price within five years and improvements in efficiency or productivity were of course optional as long as the asset market is rising.

- Short term financial goals within a shareholder value frame distracted the whole non-financial corporate sector. An anaemic UK corporate sector chose to use cash to build reserves, engage in M&A activity and bolster its share price through share buybacks and debt/equity swaps (IMF 2006). All of these moves were an attempt to improve shareholder value ratios and bolster the share price and market value of firms which via incentive schemes would usually increase top management pay.

If all this is already a matter of public record, our research below adds new insight into the social pointlessness and economic danger of these developments. Exhibit 18 below presents aggregate data on the central economic paradox of the bubble in the UK before 2007: credit was cheap and everybody was over borrowing except non-financial companies who drew very little credit for any useful productive end. There are a fair number of complications here, especially about the important role of foreign banks in UK bank lending to business and the role of UK banks in lending abroad. But none of these complications change the basic point about the nature of the problem about how little bank credit was drawn for productive purposes.

Exhibit 18: **Business and productive investment: as a share of all bank lending to businesses and as a share of GDP**



Source: Bank of England, 'The Blue Book', ONS

We calculated the total of investment in (and bank lending to) productive business by adding subtotals for three sectors: manufacturing and other production plus construction and distribution plus public and other services. Business productive investment and bank lending to productive business therefore includes everything except investment by (and bank lending to) other finance businesses and property businesses in real estate or commercial property. The graphs show that right through the bubble, productive business investment as a share of GDP was completely flat at 10% of GDP while bank lending to productive business declined sharply from 30% towards 10% mainly because bank lending to other financial firms and property developers ballooned in the bubble.

The reasons for the stagnation of investment in, and bank borrowing by productive business are complex and rooted in long standing attitudes and behaviours which long preceded the present forms of financialization. Non-financial business often choose independence from finance by funding investment from retained earnings; corporate business is often cautious about burdensome shareholder value expectations and about gearing up for higher interest payments; much non-corporate business is about sustaining a life style not growing a business; dependence on any kind of finance like bank borrowing is risky in a cyclical economy where bank lending criteria change. Demand and supply have long intersected to create a kind of stand off between finance suppliers and those running productive business.

But, in the bubble all this was set in a new context, as everybody else including households, financial firms and new players all borrowed more. *Hence, the problem of*

the pre-2007 bubble was not just that there was too much credit, but that too little of it went to the right place for generating sustainable claims on more resources and too much went into circuits predicated on asset price inflation which was unsustainable.

6.4 What is to be done?

The argument of the paragraphs above presents our structural circuits explanation of the pre-2007 bubble -a bubble which has been too much explained in terms of behavioural psychology. The problem shift is an important one because it changes the definition of our fundamental socio-economic difficulties in the UK and suggests that the distributive coalition around finance is not only dangerous but also irrelevant to solving the problems of the new instabilities of a financialized economy. Our problem is not a socio-technical problem of wealth management and portfolio allocation between classes of coupons in which funded savings or insurance premia might be invested according to some financial calculation of yield and risk. The UK's problem is a socio-economic problem about co-ordinating investment in production and infrastructure with flows of savings so as to ensure sustainability and stability by increasing material resources.

While the City of London might help with portfolio allocation, it has no expertise or competence in the co-ordination problem which here concerns us. Indeed, the distributive coalition's limited competences in this area were downgraded over the recent bubble. Private equity went for leveraged buy-outs of existing firms as it retreated from difficult, messy and less profitable activities in technology start ups. By the mid 2000s venture capital survived not as a practice but as a rhetorical label which had been appropriated by the BVCA trade association which was defending leveraged private equity. If this is to be changed and we are to find new competences outside the City, we must also recognise that the general problem of co-ordinating material investment and savings has to be solved under conditions which are specific to the UK national economy in the current conjuncture.

We have so far constructed an argument about credit and debt in a generalised form because that is what our readers expect of economic discourse about financialization. But in the paragraphs below, we change the emphasis and insist that the problems of co-ordination are specific to our national economy in the current conjuncture. By emphasising the specifics of the conjuncture and the national economy, we aim to distance our analysis of financialization from bogus epochalism. After all, it was epochalism about post-Fordism and such like which in the early 1990s licensed Blairism and disabled the centre left in Britain and elsewhere.

Our current conjunctural dilemmas can be put in the form of a series of questions. How can the UK after 2007 simultaneously meet the old capitalist requirement to generate the jobs that diffuse prosperity and the new ecological requirement to invest in curbing global warming which threatens to undermine much more than our national economy? Given the decay of pension provision, how can we meet the civilised expectation that we

will not have to work until we die? So, let us briefly and finally consider two big questions.

Where will the jobs come from (now that the British state can no longer afford Keynesian reflation)?

In the decade after 1997, the British economy did generate jobs (albeit often poorly paid jobs): some four million jobs were created in "business services" while New Labour reflation added two million jobs in state and para-state employment producing public services like healthcare and nursery education. New Labour's closet Keynesianism took care of women's employment and moderated general unemployment in the post-industrial regions like West Midlands and the North-East which have no capacity to generate private sector jobs. The state will not be able to afford to do this over the next decade.

If we ask what next in job creation, that now requires a complete change of private sector savings and investment philosophy. Jobs for women and the outer regions plus some impact on global warming will only come if we can connect the flows of savings funds with physical investment in infrastructure, low carbon technologies and repair and maintenance which are suitably labour intensive. This is very different from the City of London's version of "ethical investment" which means more fastidiousness about the coupons which your fund manager buys.

The necessary change connects with planning for a low return economy which will encourage high levels of investment which is the complete opposite of the kind of high return low investment economy which the markets have chased and created in the past decade. Put another way, Keynes' 1930s project of the "euthanasia of the rentier" needs to be reinvented as assisted suicide for shareholder value. Amongst other things, this kind of low return, high investment planning requires:

- Political identification and government sponsorship of major projects which are ecologically sound and meet social objectives. This should not be too difficult in a country like the UK which does not have a single mile of high speed train track in operation and has not built any significant amount of social housing for the past thirty years. If the financial market can't allocate capital into such projects, the state needs to figure out how this can be done by allocating savings to projects, subject to state guarantee.

- A new industrial contract between banks, fund managers and all major non-financial corporations employing more than a threshold of say 10,000 employees. Contracts would involve indicative long-term investment and employment goals, with strong discouragement of mergers and other kinds of asset trading with records of poor outcomes. The contracts would be backed by the carrot of flexible loan repayment deals for corporations who are nervous about borrowing to invest

for the long-term. The aim should be to encourage investment out of borrowing rather than retained earnings which are cyclical (and accentuate cyclicality).

- More intelligent use of the taxation system, including Tobin tax, which may have multiple roles. It could not only encourage shorter transaction chains but also prevent funds getting sucked into financial markets which generate no jobs and little long term return after the write downs are accounted for. Instead of tax breaks for financiers and bankers, offer social incentives for direct productive investment in green technologies, especially those like home insulation or durable repair which can create good manual jobs.

How do we build a sustainable politics of intergenerational transfer which recognises the limits of security through property (i.e. funded saving and home ownership)?

The crisis after 2007 represented a social turning point as well as a change in the economic conjuncture. The crisis finally discredited the social promise that the mass of the population could find security through property because funded saving and/or home ownership would provide ordinary wage earners with security in old age. The stock market crash in 2000 and the subsequent closure of defined benefit schemes had dramatised the limited long term benefits of holding ordinary shares; and the subsequent years showed that employers would not honour social obligations which had any economic cost. The housing market crash after 2007 showed that sustained gains in house prices would not compensate for non-existent pensions.

There will no doubt be an ideological struggle about how this outcome should be represented and what should be done next. The disinvention of retirement can be represented positively as more flexibilisation of the labour market, just as inadequate retirement incomes can be represented as a problem of under saving that can be solved by compelling higher rates of funded saving. In our view, it is entirely unacceptable that comfortable retirement in the UK should become, like adequate health care in the USA, a benefit which is denied to many people on the basis of their employment history and status. It is also necessary to do something for the current generation of pensioners whose property is inadequate to supplement the basic state pension. This current problem is aggravated by finance led instability which is palliated by low interest rates that reduce the value of annuities.

These issues can again only be addressed again through substantial shifts in the savings and investment paradigm. The objection to doing more for the current generation of pensioners is that this would involve politically unacceptable levels of taxation and transfer payments from those currently in employment to the retired. But if we ask how and why the current generation of taxpayers should accept the transfer claims of their indigent parents, the answer depends partly on the circuits of contribution and what, if anything, society obtains in return by way of useful resource. In the present order,

individual contributions from a low wage individual represent a failure to build a personal fund for security through property in coupons. In a more social world, the pooled contributions of many low wage individuals could make a significant contribution to the social fund for infrastructure renewal from which all of society including present and future taxpayers benefit.

The implication is that the pressing problems of senior entitlement (or junior commitment to honouring claims) can only be met if pension savings flows are directly routed into some form of productive investment, preferably, into low carbon technology investments and infrastructure whose construction would otherwise be marginal. This would usefully cut out the middleman's clip from the financial markets, and redirect savings flows out of secondary market shares into new physical investment that would increase resources. Part of this could be effected by state top slicing of pension savings for social purposes and part by setting up pension funds managers as venture capitalists not coupon traders,

Our emphasis in this section has been on raising big questions, with some possible answers, not on promising some finished alternative vision. That is quite deliberate and part of our democratic approach. What is a democracy but a political space where citizens agree on the problems to be addressed and the processes of deliberation and action through which group differences can be articulated before collective solutions are identified? If our analysis about debt as a claim on resources is correct, then we can do no more than begin to identify the issues and the direction of travel for the UK in the current conjuncture. The big democratic questions must then be debated in the old politics and the new civil society, before being decided outside finance which may become a good servant but is now a bad master.

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