

Saving the City

Sparing the UK's golden goose

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Executive Summary

The City of London is, alongside New York, the world's largest financial centre and one of the UK's most valuable economic assets. That it attracts envy and threats is no surprise. The worry is that the dangers are receiving so little interest and attention that its demise may be only a matter of time. This paper reviews the threats and proposes a strategy to maximise the long-term prosperity of the City and thereby its value to the UK economy as a whole. This paper takes the long term view spanning up to 50 years.

Whether the UK stays in, or leaves, the EU may not be critical for the City. Far more important is to press towards a single global market for financial services. The EU decision should be determined by the alternative terms available for the City, and the UK as a whole, and not jingoistic demands for sovereignty. Being part of, or just trading with, a single market means being subject to the regulations of that market.

Analysis of matters arising from the 2008 crash indicate that the two highest profile measures proposed, ring-fencing retail banks and higher capital ratios, would be counter-productive at this time. More important is to seek a single global market with a single set of regulatory principles than can be easily and universally applied. The two roads to that end, and both can be followed in different vehicles, are negotiation, globally, and downward pressure on regulations via inter-market competition.

The roles played by both regulators and auditors were inept. Too many people did too little, too late. We need fewer more effective watchdogs. To that end, the functions of auditors and compliance supervisors should be merged with auditors not appointed by directors, as they now de facto are, but by committees of shareholders with, for large companies, the participation of the Prudential Regulation Authority.

A short account of the decline of Venice in the 18th C shows what is likely to happen to the City over the next 50 years if drastic action is not taken.

Proposals: Saving the City

Six proposals for optimising the long-term health of the City are:

1. Better management measured by performance measures such as efficiency and effectiveness metrics compared with global best practice and customer satisfaction relative to competitors beyond the UK, rather than just compensation levels, internal ratios, profits and share prices
2. Lower costs and margins to compete long-term with the world's best performers.
3. Better focused and more intelligent regulation with lower costs can be, paradoxically, also more effective. This paper proposes a simple set of eight principles:
 - a. Not excluding those who wish to compete.
 - b. Ensuring that the consumer has real and substantive choice.
 - c. Not fixing prices with competitors.
 - d. Not laundering money.
 - e. Not trading outside the permitted hours.
 - f. Consumers should have access to the necessary information to make a choice.
 - g. Providing redress for product failure.
 - h. Cooperating with the media so that product failures and transgressions of these rules become public knowledge.
4. Regulation to be set globally, not by the EU or member states. The ideal of a single global market with a single set of rules, or principles, can be pursued by negotiation or downward competition as applies in corporation taxes. Basel has had successes and failures but it is the only global model in town and we need to learn from it.
5. Increased choice and competition. Since the crash, the number of banks and building societies has shrunk. Simplifying regulation would make it easier for new financial services companies to enter the market. Host country subsidiaries should be independent enough from home parents to allow either to fail without bringing down the other. Depositors should be protected by an insurance scheme modelled on ABTA/ATOL, thus allowing depositors a choice of insured versus uninsured terms.
6. Brand equity is the strongest consumer guarantee of good practice. Professional brand marketing to enhance customer satisfaction, innovation, out-performance of London's competitors.

The first two are for the City progressively to adopt. The short term pain would be offset by long term gain (relative to the alternative decline) and one should not expect a St Paul-type conversion. The government needs to lead on the next two. The current government has been indifferent to the costs of financial services regulation because the costs have been levied on the City, not the Treasury. Maybe if the Treasury picked up those costs it would hasten the necessary simplification.

Conclusion

The UK, and many other member states, would prefer a streamlined, single market EU but that is unlikely to be on offer. The scales are much more likely to be weighted the other way. The EU, with the tacit support of UK Europhiles will be making sure the “out” option so unattractive, especially for the City, that there will be no reasonable alternative to staying in.

It would be much best for the City if global financial services rules were set globally and Brussels simply matched them. London needs to help the EU to understand that having a more restrictive code is not just bad for the City but even worse for the EU as a whole. Less, but more universal, regulation would be better for everyone.

Saving the City

1 Introduction: The Challenges

The City of London is, alongside New York, the world's largest financial centre and one of the UK's most valuable economic assets. There should be no surprise that it attracts envy and threats. Some, like the House of Lords European Union Committee, take such threats seriously, writing to the government that EU plans to create a banking union risk marginalising the UK.² Yet their warning attracted scant notice.³

If the dangers to the City receive so little interest and attention, its demise may be only a matter of time. This paper reviews the threats, and proposes a strategy to resist them and to maximise the long-term prosperity of the City – and thereby its value to the UK economy as a whole. This paper takes the long-term view spanning up to fifty years.

Although the paper's concern is the City as a whole, in the light of the high visibility of banking issues in the past five years, it gives particular attention to banking. The various other subsectors, such as fund management, insurance underwriting, capital issues, capital trading, mergers and acquisitions, law, legal and accountancy are broadly included but not addressed individually.

A 'stay in' or 'opt out' EU referendum is not expected before 2017. UK Prime Minister David Cameron insists that the facts are not yet available for the electorate to make a sensible judgment before the next election:⁴ without seeing the best realistic terms for staying in, nor the best realistic terms for the UK outside the EU, one cannot know which will be best for the City and the UK. Maybe the horse-trading will bring the 'in' and 'out' options so close together that it will make little difference. Maybe the terms will diverge so that the best decision becomes transparently obvious. Maybe the promised referendum will not be definitive and (like other EU countries) we will be asked to vote again to get the 'right' answer. Even then, whatever the UK opts for five years from now could still be reversed in subsequent years and decades. Plainly, the UK-EU relationship question is not going to be settled quickly.

That leaves the City in an unsettled position. The UK argues that to have one of the two dominant global financial centres within the EU (the other being New York) is a great strength for the EU as a whole. Accordingly, other

² EU Economic and Finance Sub Committee letter to Greg Clark MP, Finance Secretary, 4th December 2012, on Banking Union.

³ Likewise the warning for the City: "London's Competitive Place in the UK and Global Economies," Oxford Economics Research Report for City of London Corporation, Economic Development Office, January 2011

⁴ London speech, 23rd January 2013.

member states should do everything they can to strengthen it. Frankfurt and Paris, however (and to a lesser extent Amsterdam) see it as unfair that the UK should hog this valuable sector; some of it, they reason, should be handed over to them. In the words of Professor Tim Congdon: 'Public statements have been made this year by French ministers which are blatant in their hostility to the City of London, even though they also betray an obvious wish for the wealth and employment associated with international financial services to relocate to Paris'.⁵ Given the power balances within the EU, it is entirely possible that regulation may be employed to rein back the City's independence and increase the business of other EU centres. (In this debate, the status of Switzerland, another important financial centre, is of special interest. Being, in effect, an associate EU member, it has many of the advantages of membership and yet enough independence to set its own priorities.)

This paper argues that, however important regulations and supervisors are for markets, there is a point beyond which regulation becomes inefficient, reducing value and imposing excessive costs on businesses, customers and the economy. As each market is defined by its own set of regulations, the more regulations there are, the more difficult it is to harmonise markets – such as progressing towards a single EU internal market as envisaged the Commission's Financial Services Action Plan.⁶ Excessive regulation also creates barriers to entry, reducing competition and innovation.

We need to establish the 'ideal' level of regulation that keeps markets working well without imposing unnecessary burdens. There are two roads toward this ideal: either negotiation of shared global standards and market-to-market independence leading to experimentation; or the erosion of excessive regulation as a result of competition between those markets. Basel, which only applies to banking, has had successes and failures. But as the only global model in town right now, we should see if it can be made suitable for the purpose of finding the ideal regulatory level.

The penultimate section looks at the rise and fall of a world financial centre of yesteryear – what gave it prosperity and what caused its collapse. History never repeats itself exactly, but there are lessons to be learned.

Finally the paper sets out recommendations for the City and for the UK government to prolong and develop the City's global strength.

⁵ 'The City of London under threat: the EU and its attack on Britain's most successful industry' *An essay based on a talk given to the Bruges Group in London on 26th October, 2009*

⁶ http://ec.europa.eu/internal_market/finances/actionplan/index_en.htm

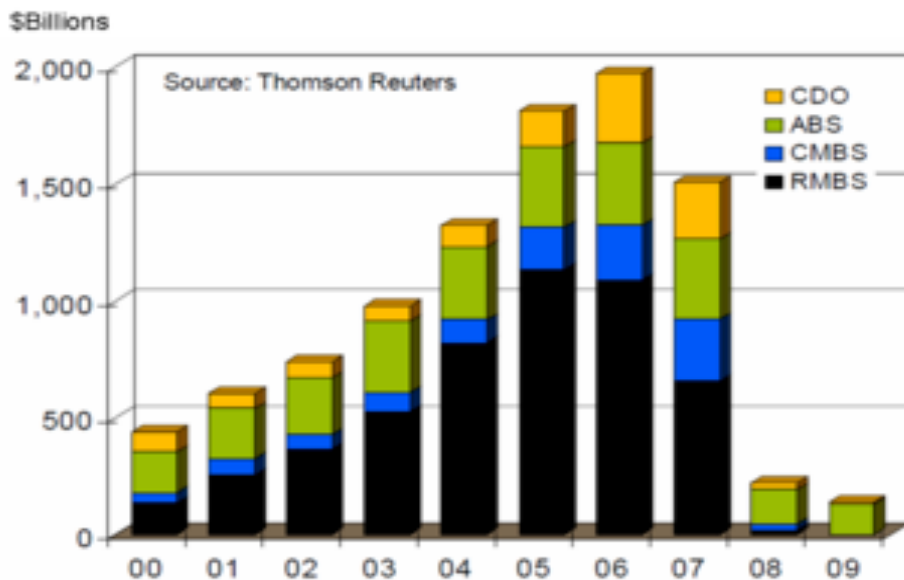
2 Matters Arising from 2008

This section looks at four issues arising from the crash: the cause, management failure, “too big to fail”, capital ratios and regulatory jurisdiction.

Causes of the Crash

Banking is only part of the UK’s financial services sector, albeit a large part. The 2008 crisis came close to destroying the largest British banks; the government, along with international colleagues, successfully rescued them, though whether other strategies would have been better is open to debate. The troubles actually began in the US, with the Carter and then the Clinton administrations instructing US banks to give mortgages to those with little hope of repaying them. The banks then hid these bad debts in packages of good debts and sold them on through such opaque securitised instruments as Collateralised Debt Obligations (CDOs); the bar chart below shows their exponential growth. A number of non-US banks joined in, notably in the UK, Germany and France. Northern Rock and other banks and building societies also fuelled the property bubble with high mortgages and poor assessment of risk and liability management. Like US banks, lent money to people who had no hope of paying it back when the credit boom subsided, as it inevitably did.

Securitization Market Activity



The regulators, the Securities and Exchange Commission (SEC) in the US and Financial Services Authority (FSA)/Bank of England in the UK, failed in their primary duty – namely to rein back financial institutions from excessive risk

and bad business practice – even though they were warned of the impending collapse.⁷

Management

When Rolls-Royce was rescued in the early 1970s, its car manufacturing section was deemed a no-hoper and sold off to BMW and VW. Yet both the Rolls-Royce and Bentley brands are now thriving under German management. Indeed, they are expanding their global dealer networks.⁸

The moral is that if the City wants to win in world markets, it needs to have the best financial sector managers in the world. And the quality of management is not measured by their compensation packages. Newly minted MBAs would do a better job on the boards of some banks than their present incumbents.

And perhaps managers need to be more assertive against regulatory threats, even those from within the UK, where the FSA and the Financial Conduct Authority (FCA) that has now succeeded it have taken the view that if an investor loses money it is always the fault of the bank or other financial institution in which the investment has been made, or the financial advisor, or both. This erroneous approach is damaging for the City, bad for Britain and ultimately against investors' long-term welfare – since it is they who end up paying the costs that these regulators create.

Too Big to Fail

In a classic competitive market, banks will fail from time to time. High deposit rates will warn canny investors that a bank is struggling to raise cash. Those who miss the signs will get caught. But that is inherent in the workings of a market: otherwise there would be no incentive for investors to act prudently. In reality, though, the size issue is difficult: a bank large enough to compete in the global marketplace will be too big, within the British context, to be allowed to fail. This paper proposes that, in the UK, competition is increased so that no local company is “too big to fail” and yet it can still be

⁷ “The Financial Crisis: Is regulation cure or cause?” Adam Smith Institute Report, Tim Ambler, 27th November 2008. This analysis has since been endorsed by the Treasury Select Committee’s 18/1/13 report endorsing the appointment of John Griffith-Jones as Chair-designate of the Financial Conduct Authority “He must restore the credibility of the conduct regulator. The FCA is the successor to a body which failed consumers. Although it devoted a great deal of time and effort to conduct matters, it left consumers exposed to some of the worst scandals in UK financial history. It created a 'box-ticking' culture whose benefits were far from evident and which still failed to pick up major failures in the making.”

⁸ ‘Bentley aspires to 10 per cent increase in sales’, Financial Times, 14 January 2013. Bentley, now owned by VW/Audi, plans to establish up to 40 new dealerships in the next two years worldwide.

part of a major global player. Santander is an example: the UK operation has been made self sufficient in the sense that it could fail without fatally damaging the parent and vice versa.

Instead of addressing that, the authorities and the media have diverted their attention to the links between investment ('casino') and retail ('High Street') banking. That misses the point. There is little if any evidence that this was a significant issue (apart from, arguably, the Royal Bank of Scotland).⁹ The investment side of Barclays seems to have saved the demise of the retail side. As an independent member of the Bank of England's Financial Policy Committee pointed out, some failures were pure retail, some entirely wholesale and some linked.¹⁰ There seemed to be little if any connection between linkage and failure.

All the building societies that converted into banks are now extinct – though this is the same 'retail' sector that the Vickers Report extols. Just as Rolls-Royce was rescued thirty years earlier as being 'too big to fail', so RBS, HBOS and the others had to be rescued by government because for the same reason. It was a question of size, not retail-wholesale linkage. In short, the Vickers recommendation for ring fencing rests on shaky foundations.

The discussion usually conflates two different issues: saving depositors' money and the collapse of the corporation. By introducing depositors' guarantees, up to £85,000 per account, the former is to a large extent protected (though it is rather surprising that the EU permits these, in effect, subsidies). An open market alternative would be to allow banks, and other deposit businesses, to have an insurance scheme similar to that for travel agents (ATOL). The Bank of England would act as insurer and premiums would be on a sliding scale according to the banks' capital and liquidity ratios and other data.

The second issue can be addressed by a different form of ring fencing – namely the independence of national subsidiaries from their parent companies. Santander provides an example:¹¹ in the global market they can use their full corporate muscle, but in the national context they can be regarded as independent, and can be allowed to fail.

⁹ 'Bank regulation: Can we trust the Vickers Report?' Adam Smith Institute Report, Tim Ambler and Miles Saltiel 17th November 2011.

¹⁰ Michael Cohrs' evidence to the Treasury Committee 15th January 2013.

¹¹ <http://www.santander.co.uk>, About Santander, 'Liquidity is held to cover both FSA and internal stresses, which cover a variety of periods and scenarios across the whole business. From both the point of view of funding business as usual financing) and liquidity (stress scenario financing) no reliance can be placed on the parent company (Banco Santander), and this has to be demonstrated to the Financial Services Authority.'

Capital Ratios

Ring fencing of retail and wholesale banking is primarily a UK proposal for banking reform. The main international approach has been Basel III, the proposal to raise capital ratios. Although higher capital ratios might have averted the crash if applied as the market hotted up, it is the wrong medicine for the recession we are now in.¹² The effect will be to prolong the recession by limiting lending to small and medium-sized enterprises, which need funding if they are to grow.

This issue is cyclical. Increasing capital ratios now is like a doctor applying ice packs to someone suffering from hypothermia. Increasing them in the incipient boom, however, would indeed have been valuable. But even so, leverage ratios and liquidity are far more important than capital ratios, especially when one bank's loans become another bank's 'capital'.

Regulatory Jurisdiction

One final point is jurisdiction. Former FSA boss Hector Sants pinned the blame for the Northern Rock collapse on the Bank of England and the Treasury. In September 2007, he says, the FSA saw the Northern Rock liquidity crisis and pressed for Lloyds TSB to be given the liquidity to acquire Northern Rock but were refused.¹³ That may have been due to Bank of England concerns about whether Brussels regulations would permit such intervention. So we have the FSA thinking that intervention is outside their jurisdiction and the Bank of England being unsure of theirs.

Similarly, the FSA determined that the UK activities of Icelandic banks and their subsidiaries was a matter for the Icelandic financial regulator, not the FSA. Again, a phone call might have been a good idea, but none seems to have been made. It is a poor way to protect the UK investor, who should not have to look behind the brass plate on the door to determine the ultimate owner: if a bank's branding says 'London Securities PLC' and it trades in London, the UK investor is entitled to assume that it follows UK regulations, and is supervised by the UK regulator.

What makes all this more absurd is that, in the European Economic Area (EEA), the home country supervises banks in host countries but is not

¹² 'How Basel III threatens small businesses,' Adam Smith Institute Report, Tim Ambler, 27th July 2011.

Michael Cohrs, independent member of the Bank of England Financial Policy Committee in his evidence to the Treasury Committee (15th January 2013) also doubted whether raising capital was the right approach. He suggested that selling non-trading assets might be better.

¹³ 'Bank of England and Labour to blame for Northern Rock run – Hector Sants,' Guardian, Jill Treanor, 13th June 2012

responsible for compensating private citizens of the host country – who have to be compensated by the host country.¹⁴

This issue relates to the one-to-one relationship between a set of regulations and a market mentioned in the introduction. A market is defined by the regulations that govern it and logically, therefore, there cannot be an EU single market in financial services until it is governed by a single set of regulations.

The EU is moving toward having the single internal market in financial services, for which the UK has long campaigned. When UK Prime Minister Gordon Brown turned financial sector regulation over to Brussels in 2009, his move was entirely in line with this development.¹⁵

But there is a big difference between a single market with a minimal set of common regulations and a club designed to protect the vested interests of the big players in each country. As two MPs, Bill Cash and Bernard Jenkin have pointed out, the EU leans more to the latter model than the former.¹⁶

The danger of leaving financial services regulation to an ill-informed Brussels can be seen in their proposals to revise the original Markets in Financial Instruments Directive (MiFID I), which took effect in November 2007. The House of Lords EU Committee commented that: “There could be serious repercussions for the entire EU financial services industry were the leading position of the UK within the global financial sector to be undermined because of this approach. It would also have a negative impact on innovation.” It went on: “We conclude that the MiFID II proposals have been rushed, and risk creating confusion rather than providing clarity in terms of the regulatory framework for investment.”¹⁷

The Northern Rock disaster, for example, was further compounded when Brussels intervened in the UK rescue package. London wanted to restore as much as possible of Northern Rock to normal trading as soon as possible. But as Professor Congdon pointed out,¹⁸ Neelie Kroes, the Competition Commissioner, demanded ‘compensatory measures’ to offset the Treasury’s rescue. “As a result, 2000 people were put out of work in the UK’s poorest region for no good reason.”

¹⁴ “Iceland triumphs in Icesave court battle,” Richard Milne, Nordic Correspondent, Financial Times, 28th January 2013.

¹⁵ “London ‘Sold down the Rhine’ say experts,” Adam Smith Institute Press Release, 22nd June 2009.

¹⁶ Email from Lord Flight, 7th February 2013.

¹⁷ “MiFID II: Getting it Right for the City and EU Financial Services Industry,” European Union Committee – 2nd Report, 3rd July 2012.

¹⁸ Northern Rock and the European Union, Pamphlet for Global Vision, London, 2008.

Conclusion

It is a sad reflection on the post-crash analysis by the conventional thinkers that only two major ideas have surfaced – ring fencing and raising capital ratios – and both of them are questionable. The solution does not lie in more regulation or more regulators, but in effective supervision – that is, auditors and a few regulators working intelligently together and doing what they are paid to do. The issue is not something for the UK alone but has to be considered in the context of the EU, the other primary source of regulation. Perhaps Switzerland provides a useful model.

The EU and Switzerland

This section is divided into four subheadings, namely:

1. *Eurozone Federation.* The eurozone will probably continue its march toward a federalisation – otherwise, the euro will fall apart. Germany would not tolerate a federal state it did not lead, largely because it would not believe that financial disciplines would be enforced. But exiting the euro is unattractive to Germany not least because the euro's weakness has benefited German exports (notably motor vehicles).
2. *Banking Union.* As the House of Lords reported, the proposed banking union, with the UK opted out, could be very dangerous for the City.¹⁹
3. *Financial Transaction Tax.* This tax may be damaging in terms of trade, economics and economies but the French see it as an admirable way to shift money from London to Brussels. Economic logic may talk it out, but if not, then the UK needs a seat at the table that introduces and manages it.
4. *A Swiss Solution?* Would the UK like the same EU deal that Switzerland enjoys? We need to be clear about the myriad trade arrangements agreed with Switzerland and how those may develop.

Eurozone Federation

Keith Boyfield discussed the threats posed by the eurozone in a recent article for the *Wall Street Journal*.²⁰ He captured the importance of the euro for the City: "More than twice as many euros are traded in Britain than in all the eurozone countries combined. Over half of all derivatives traded in the UK are euro-denominated, more than sterling- and dollar-denominated business put together."

Boyfield listed three main threats:

- First, the European Central Bank (ECB) is seeking to require any clearing house that handles more than 5% of a euro-denominated product to be based in the eurozone. The UK government claims that this infringes the single market but when it goes to the European Court, the judges may take the view that the stability of the euro is

¹⁹ European Union Committee, 7th Report of Session 2012–13, "European Banking Union: Key issues and challenges," 12 December 2012

²⁰ 'New Threats to London's Euro-Dominance: Continental regulators seem to be acting in the interest of euro-zone firms in working to reduce Britain's share of euro-denominated financial business,' *Wall Street Journal*, Keith Boyfield, 30th September 2012

more important. Note that national governments blame speculators, not their own economic policies, for currency weaknesses, and the City in this portrayal is a world capital of financial speculators.

- Second, as mentioned above, the EU financial market(s) will be governed by one set of regulations determined by board of one member per board, plus a representative of the ECB. So the UK will have just one vote among 28. The Eurovision Song Contest gives a pretty good indication of how the voting might go. Among EU leaders, the British are not popular. Banking scandals have not helped.
- Third, the proposed takeover by the London Stock Exchange of LCH Clearnet Group, which operates clearing houses in London and Paris. The French regulators may well impose restrictions, in effect transferring some euro business to Paris. The deal might be good for the LSE but bad for the City.

These threats are undoubtedly real, though the article does not consider how the City should respond to them. The first and third are anti-competitive, whereas the second furthers the cause of the single market and is therefore pro-competitive within the EU context – but potentially anti-competitive (protectionist) in the global context. This is the conundrum discussed in the third last section where the paper considers two roads toward reducing excessive regulation.

In addition to challenging the first threat in the European Court of Justice (ECJ) and perhaps the World Trade Organization (WTO), the City might also consult the United States authorities. How would they feel about US financial institutions being barred from handling a euro-denominated product where it holds a significant chunk of the action? The Americans' weight on the question might be more effective than that of the UK alone.

Similar arguments apply to the third threat. It is clearly against the single market principle if any member state seeks to bias trade against other potential members of the single market. In this case, the UK would be entitled to take any French-biased merger approval to the ECJ, which should uphold the principle.

More generally, the City should expect the eurozone to seek to benefit itself at the expense of non-eurozone members. The lower the level of EU financial regulation, the more difficult that will be. It is therefore foolish for the Bank of England and the FCA to brag about the UK being the 'best (i.e. most) regulated' market in the world. The message should be that, given good marketing and regulatory supervision, the EU could and should have the least restricted financial markets in the world.

Classic branded markets require only light regulation because traders know that their reputations are their most valuable assets. Great marketing will not protect a poor product, indeed it will kill it, but the absence of great marketing will hobble the growth a good product should enjoy. The financial sector and its regulators have only a weak grasp of such marketing

considerations²¹, though branding is a far better guarantee of consumer protection than any amount of regulation and supervision – especially that done by agencies like the FCA that display little understanding of consumers and their buying decisions.

Banking Union

The proposed EU banking union is a serious threat to the City, even though the UK intends to opt out of it. To quote the European Union Committee of the House of Lords again:

“There is a significant risk that the UK will be marginalised as banking union participants move towards closer integration. This in turn threatens to fracture the single market, as the authority of EU-27 bodies such as the European Banking Authority and the European Systemic Risk Board comes under threat. The Government’s assurances about the impact on the City of London may prove misplaced. UK isolation in debates of such fundamental importance would be disastrous.

“The original banking union proposals set out a three-pronged approach: a single supervisory mechanism, a common resolution mechanism and a common deposit insurance scheme. We regret that this coherent model has already been undermined by political pressure, led by Germany.”

The Committee continues:

“It is vital that there should be no conflict of interest between the ECB’s supervisory and monetary policy tasks. The ECB needs to be fully accountable, both to the European Parliament and to national parliaments, in the exercise of its supervisory powers. There must be equality in the supervisory decision-making process within the ECB between euro area and non-euro area Member States who wish to participate. Equally, the role of the EBA in representing all 27 Member States must not be undermined and the Commission must defend the integrity of the single market as a whole.

“The Commission’s original proposals do not go nearly far enough to meet these concerns.”

Financial Transaction Tax

The theory of financial transaction taxes (sometimes called a ‘Tobin Taxes’) is that they make fewer, longer term transactions more attractive relative to more frequent ones and thus reduce market volatility, which is said to have been a causal factor in the 2008 crash. It was not, of course; and the real motivation behind such taxes is a visceral hatred of hedge funds and

²¹ I recognise this is a contentious claim but as a practising and as an academic marketer for over 40 years I have witnessed too many appalling bank advertising campaigns and entries for marketing awards. In financial services companies, marketing is rarely represented at board level.

speculators. Vienna economist Stephan Schulmeister reviewed the literature on financial transaction taxes and found the pros and cons well balanced,²² but did not take into account the effect on the City – which, by reducing both the volume and value of transactions, would be negative.

How negative can be judged by the fact that in the average case, “at a tax rate of 0.05%, tax receipts are estimated at roughly 1.1% of GDP” – but “tax revenues in the United Kingdom would be extremely high, amounting to roughly 6.9% of GDP” (p.14). In other words, this tax would not only provoke a massive shift of funds from London to Brussels: it would decimate City trading. The amount involved would be enough by itself to justify the UK leaving the EU.

Yet if the eurozone (or the EU as a whole) decided to impose a tax on financial transactions, then we understand that even if the UK left the EU, any EU company conducting a transaction in London would still be liable for the EU tax – and it would have to be collected by London.²³ The same would apply to any other non-EU transaction.

Again, the UK would not be able to rely on the ECJ for support and would need to look to the US and the WTO once more. The US would presumably be hostile to the unilateral hijacking of transactions for EU tax purposes (the US intended a similar tax of its own in which case double tax relief would probably apply).

In short, as the House of Lords has pointed out:²⁴ “We find the Commission’s proposed residence principle to be impractical and unworkable, and conclude that there is a significant risk that financial institutions would relocate outside the EU if an FTT is introduced.”

A Swiss solution?

Norway should be rejected as a model for a post-EU UK, because, as Norway’s Foreign Minister has pointed out, the country has to comply with almost all the EU regulations that the UK dislikes, but lacks a seat at the table that creates them.²⁵ Norway does have some small influence through its membership of the European Economic Area (EEA) and, partly because it is

²² *A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal*, Austrian Institute of Economic Research, 2009, WIFO Working Paper No. 344

²³ Email from Lord Flight, a member of the House of Lords Economic and Finance Sub Committee, 7th February 2013.

²⁴ “Towards a Financial Transaction Tax?” House of Lords, European Union Committee 29th Report of Session 2010–12, 30th March 2012.

²⁵ ‘Norway Warns UK Against EU Exit: Norway’s Foreign minister has cautioned the UK against leaving the EU. Norway is not a member and is used as a model by Euro-skeptics of how the UK could continue after leaving the EU. ‘We are not at the table when decisions are made’ he said’ <http://www.bbc.co.uk/news/uk-20830201> 13:26 Sun 23rd Dec 2012

small, it is allowed to opt out of some minor directives – though it needs permission to do so. Such permission might not be granted to a non-EU UK.

Norway is even signed up to the EU fisheries policy, which has been a disaster and is top on the UK government's renegotiation list.²⁶ Iceland, another EEA country that retains considerable autonomy in fishing, ensures it has adequate fish stocks because the same people who harvest the stock are responsible for managing it. EU fishing fleets, by contrast, harvest stocks but manage nothing. The damaging results are brought into relief by catch limits that result in half-grown fish being thrown, dead, back into the sea.

Arguably the UK, as a larger country, could negotiate a better deal than these small ones. But precisely because it is a major member state, the EU would be reluctant to concede a better deal for fear of being obliged to grant similar agreements with France, Germany and Italy.

Perhaps a better model is Switzerland, where the population is even more hostile to EU membership than that of the UK: only 6% favour joining.²⁷ From an EU perspective, Switzerland is vital with respect to power and transport linkages. It has even agreed, perhaps surprisingly, to the free movement of peoples,²⁸ being part of the (passport-free) Schengen agreement (along with Norway, Iceland and all member states of the EU except the UK and Ireland). Despite mounting security concerns, Schengen membership will be compulsory for new EU members.

Switzerland is effectively part of the EU. It is part of the single market in all sectors save one – financial services – though judging by the freedom that Swiss firms such as UBS have in London, the exemption has not prevented Swiss financial firms operating in the EU. And Switzerland has 130 different EU agreements covering all other areas, including those where the UK may be seeking opt-outs, such as employment law.

In a book exploring the consequences of a UK exit from the EU, author David Charter concludes that despite the welter of new EU regulations spawned by the economic crisis, from bankers' pay to institutional capital requirements, "leaving the EU causes the greater headache for the City because of the

²⁶ EU website: 1981-2015 'The Community has three fisheries agreements with Norway, namely the bilateral, the trilateral and the neighbouring agreements. The bilateral arrangement covers the North Sea and the Atlantic, the trilateral agreement covers Skagerrak and Kattegat (Denmark, Sweden and Norway) and the neighbourhood arrangement covers the Swedish fishery in Norwegian waters of the North Sea.'

²⁷ The World This Weekend, BBC4, 1pm, 13th January 2013.

²⁸ The EU has a closer relationship with Switzerland than with any other country outside the EEA. Switzerland is the EU's 4th largest trading partner, and the EU is Switzerland's largest trading partner. More than 1 million EU citizens live in Switzerland, and another 230,000 cross the border daily to go to work. Some 430,000 Swiss citizens live in the EU. In 2011, the EU imported €91.2 bn in Swiss goods (5.4% of total EU imports) and exported €121.7 bn worth of goods to Switzerland (7.9% of total EU exports). The EU accounts for 68% of the Switzerland's foreign trade. Taken from EU website http://eeas.europa.eu/switzerland/index_en.htm

uncertainty of Britain's future relationship with the continent and the loss of any kind of control over its future actions."²⁹

Conclusion

Switzerland does seem, *prima facie*, to provide an alternative to EU membership as a model for the City's future development. But further analysis and a better understanding of the attitudes of Frankfurt, Paris and Amsterdam would be needed before a conclusion could be reached. Though other EU leaders resent the dominance of the City and are exasperated at the UK's resistance to deeper union, pride in the European project and the UK's large contribution to the EU budget make it likely that many of them will aim to make the 'out' option so unattractive that there is no reasonable alternative to staying in.

Of course, the UK, and many other member states, would prefer a streamlined, single-market EU. But that is unlikely to be on offer.

²⁹ *Au Revoir, Europe What if Britain left the EU?* Biteback Publishing, London, 2012, pp.258-262

How Many Regulators?

The questions of jurisdiction and sovereignty are intertwined. The paper argued earlier that a set of regulations defined a market. Accordingly, if the EU truly has a single internal market for financial services, then it must have a single set of regulations and the UK would have to cast aside 'sovereignty' in this respect. As mentioned above, Gordon Brown, as Prime Minister in 2009, largely made this concession.

UK demands for a single market have always included an acceptance that the UK financial services sector must be free for other EU firms to enter. In return, we expect other Member States' financial markets to be open to UK firms. Indeed Britain has usually gone further than that and opened UK borders in sectors such as financial services and utilities, before other member states reciprocated – the idea being that the UK's leadership will promote the open markets concept. It is questionable whether that was a wise strategy and whether it worked.

What is beyond doubt, however, is that Frankfurt, Paris and Amsterdam want access to the larger UK financial services market more than the UK wants access to the German and French markets. Whether the UK stays in or leaves the EU, UK financial services will prosper more with a single European market than they would with national barriers being erected – in which case, we will continue to need one set of regulations and a place for the UK on the board that sets those regulations. The alternative – two markets each with its own set of regulations – could see the UK frozen out of a continental market that is smaller now but has the prospect of growing much faster.

Nevertheless, every country should supervise the regulations for trading within its own market. The 2008 Iceland problem arose from the arrangement that groups headquartered in EEA countries are supervised not by the country they trade in but by their home-country supervisor. This should stop.

In this respect, the impact of the new EU arrangements is not yet clear. If the intention is to have one set of regulations for the whole of the EEA, which are in turn supervised by the responsible agencies in those countries (the Bank of England and the FCA in the case of the UK), that is fine. True, such an arrangement would still leave the door open to bias by the supervisors in favour of their own nationals; but even that would be better than the present situation of, say, allowing a Latvian company trading in London to flout the oversight by the UK supervisor on the grounds that they answer only to Riga.

The 'answerable to whom' issue is becoming steadily more complex as some jurisdictions seek to impose their own rules on other countries. This is ostensibly limited to their own citizens, but mission creep extends the remit. To take an American example, the author of this paper had to complete forms for the US Foreign Account Tax Compliance Act (FATCA) even though neither a US citizen nor taxpayer. The stockbrokers advised him it was compulsory because they had US interests even though he did not.

Businesses are used to dealing with different levels of regulation – at the level of trading in the host market by the local company and at the global level where it is headquartered. If UK companies want to trade in the EU, they will have to comply with EU regulations in those host member states.

However, the EU regulatory authorities are growing more complex. For example, in addition to member states seeking to protect their vested interests from competition, plus the rule-making in Brussels, we now have the European Securities and Markets Authority (ESMA). A quango that supposedly 'fosters supervisory convergence both amongst securities regulators and across financial sectors by working closely with the other European Supervisory Authorities competent in the field of banking (EBA), and insurance and occupational pensions (EIOPA),³⁰ it will inevitably be superimposing its own ideas on the regulatory structure.

³⁰ <http://www.esma.europa.eu/page/esma-short>

Negotiation or Competition?

As noted earlier, a market is defined by its set of regulations. But the conditions for trade are optimised when those regulations are held to the minimum necessary. Determining that 'minimum' is clearly difficult, even subjective.³¹ The paper starts from the position that financial services should be treated like any other branded, competitive market: the regulations should be no more than the basics for countless other products.

That needs no more than, say, eight rules:

- a. Not excluding those who wish to compete.
- b. Ensuring that the consumer has real and substantive choice.
- c. Not fixing prices with competitors.
- d. Not laundering money.
- e. Not trading outside the permitted hours.
- f. Consumers should have access to the necessary information to make a choice.
- g. Providing redress for product failure.
- h. Cooperating with the media so that product failures and transgressions of these rules become public knowledge.

Perhaps these can be reduced to just the three broad principles:

- Strong competition policy (which includes prohibiting price fixing)
- Regulation to ensure repayment and honouring of contracts.
- Clear law stating what is financial crime and how it is policed.

Such principles focus regulation on the real issues. For example, malpractice should be rooted out never mind the fine print of the regulations. At the same time, pointless or disproportionate rules should be eliminated – such as 'money laundering' rules that require the treasurer of a village church flower fund has to show passport, utility bills and prove that the £100 balance has not been laundered, while HSBC subsidiaries are able to launder billions of drug money.³²

Less regulation will lead to better regulation. It is noteworthy that the extent of malfeasance in the last twenty years has grown in proportion to the growth of financial regulation. Regulators are unable to see the wood for the forest of regulatory trees.

If all world financial services markets followed these, and only these, rules and principles, and answered to a single supervisor, we would have a truly global market. That would maximise consumer value, choice and indeed the

³¹ "Simple Rules for Complex Systems: Streamlining the UK's Financial Regulation Regime," Adam Smith Institute Report, Tim Ambler and Eamonn Butler, 13th July 2012

³² "HSBC will pay \$1.9 billion for money laundering," USA Today, Kevin McCoy, 11th December 2012

City's opportunities and profits. There are two roads to that ideal from where financial markets are today.

Negotiation of global rules

First, the UK must lead the way in showing why unnecessary and wrongly conceived financial regulation is bad for national economies and for consumers. In creating the FSA, the government did exactly the opposite and led the way toward greater regulation with disastrous outcomes: the 2008 crash demonstrated the failure of this approach and the incompetence of the regulators it spawned. We must learn from that and spread the understanding that markets need simple rules, which everyone can understand and which need few supervisors who act promptly, proportionately and intelligently.

By these measures, the Basel banking accords are open to criticism. Certainly, Basel I and II helped deepen the 2008 crash and Basel III was an over-reaction to it. But while Basel is imperfect, it is the only organisation that can set global financial regulations. The positives include:

- Basel works slowly. Care is needed that new rules do more good than harm. For example, hasty rules to prevent excessive growth in a bull market are likely to inhibit growth in the consequential recession.
- With such a large membership, it is hard to agree anything and that is as it should be, namely that only the essentials are agreed.
- Even when new rules are agreed, there is a lengthy implementation period, during which financial institutions will press for the regulations to match prevailing conditions. (Thus the implementation of the Basel III capital requirements is being delayed because of the recession.)

Moreover, the US sees itself as a global leader and is inclined to resist EU regulations that it believes go against its own interest. Following the same logic, one of the attractions of the negotiation road is the opportunity to press the EU to agree only the same rules as are agreed globally and no more. If the EU had tighter rules than Switzerland, New York and Shanghai, it would lose business to those other global centres.

The WTO may not have achieved as much as some would have hoped, but it has done what it could and serves as a model, learning from its flaws, for how the negotiated path should be taken.

Downward Regulatory Competition

The second road starts from the view that negotiating a global set of rules will be unproductive and that inter-market competition will whittle down regulation to the desirable minimum. If Singapore, say, finds that it can regulate its financial sector with far fewer regulations, then those countries wishing to compete with Singapore will have to match them or lose business; or they might pioneer some other, even more attractive set of regulations.

In this model, competition exerts a downward pressure on regulation.

Taxation is a more obvious example. Ireland's reduction in corporation tax attracted large companies to move there.³³ HM Treasury are unlikely to admit it, but the UK's cutting of corporation tax rates is probably an example of inter-market competition.

So far, similar examples of downward competition are hard to find in the field of regulation; but with increasing calls for simplification, they may appear. In any case, the two roads are not mutually exclusive and both can be pursued.

³³ WPP is an example although it has since returned to the UK.

From Boom to Bust: Venice

Seventeenth-century Venice provides some interesting lessons for the twenty-first century. City. The grandest palaces in Venice date from this time, long after Venice had lost its military, imperial, manufacturing and commercial power. It was by then only a shadow of its former self; but it still had a high reputation for financial probity. The word of a Venetian banker was his bond. Unlike its competitors it did not default on repaying deposits. And it was financially innovative.

By the middle of the seventeenth century, the financial sector had become the chief economic support for the state. The bankers were making big money, wealth disparity reached new peaks and the bankers wanted to display their wealth by building the ostentatious palaces we now admire.

In 1587, Venice opened the Banco della Piazza di Rialto as a state initiative to hold merchants' funds on safe deposit and enable financial transactions to take place without coins. This was arguably the first financial institution in the modern sense. Though it failed thirty years later through making unsecured, or inadequately secured loans, its role was filled by the Banco Giro, which persuaded the Venetian government's creditors to accept payment in the form of credit with the new bank. This created a huge new opportunity: namely raising public finance on the basis of 'guaranteed' credit.³⁴

The Cretan War (1645-1669) was as damaging to Venice's fundamental wealth and international power as the twentieth-century world wars were for the UK. The extensive Venetian empire shrank back to the homeland. But the Cretan War had to be paid for, so the financial sector was actually reinforced. Venice's financial innovation and its long-standing reputation as a reliable finance centre attracted funds from all over the then developed world.

In short, the financial sector was the last part of Venice's economic power to decline. Yet the realities – its loss of empire, its entanglement with other Italian city states (the EU of its day), its high margins and costs that meant better deals could be done in Amsterdam – eventually eroded it.

The decline of Venice's financial reputation – its brand equity – lagged its decline as a commercial and empire builder, though it created the Venice we know today. One can visualise future tourists gliding down the Thames past the ivy-clad towers of Canary Wharf and asking who built such monuments, and why.

Venice in the seventeenth century has close parallels with the UK in the last hundred years. That does not mean that events will always follow the same course: Switzerland became a financial capital without ever being a global power. But Venice does warn us against complacency. Financial success today does not guarantee financial success tomorrow.

³⁴ Taken from <http://www.historyworld.net/wrldhis/plaintexthistories.asp>, accessed 13th January 2013

How to Save the City

Six proposals to optimise the long-term health of the City are:

1. Better management measured by performance, not compensation.
2. Lower costs and margins with market-based performance measures, not just profits and share price.
3. Better focused and more intelligent regulation with lower costs.
4. Regulation to be set by the global market (Basel improved and extended to all financial services), not the EU or other states.
5. Increased choice and competition.
6. Professional brand marketing to out-perform London's competitors and promote customer satisfaction and innovation.

The first two are for the City progressively to adopt. The short-term pain would be offset by long-term gain (relative to the alternative of decline).

On the next two, the government must take the lead. The current government has been indifferent to the costs of financial services regulation because the costs have been levied on the City, not HM Treasury. Maybe if HM Treasury picked up those costs it would hasten the necessary simplification.

The last two are for the City to lead but only when the government has the wheels in motion on the previous two. We cannot expect to improve choice, competition, brand marketing or innovation until the brushwood of excessive regulation has been cleared away.

As noted above, the UK, and many other EU Member States, would prefer a streamlined, single-market EU, but that is unlikely to be on offer. The scales are much more likely to be weighted the other way.

Management

The number of people employed in the City has shrunk since 2008 and the present slimmed-down business model will serve the City and the UK economy well enough in the short term. In the longer term, increased international competition will require an altogether better managed approach. Margins, costs and personnel numbers need to reduce further. Managerial capability needs to be measured not by compensation but by performance and productivity.

The 2008 crash revealed a banking management that was not up to the job. The big rise in complaints to the Financial Ombudsman Service (FOS) indicates just how far bank managements are dislocated from customers and unresponsive to pressures for improvement. LIBOR and money-laundering scandals show that management either had little idea of what their own managers were doing or did know and were complicit.

Performance measures should focus on efficiency and effectiveness compared with global best practice, and on customer satisfaction relative to competitors beyond the UK – and not just on internal ratios, profits and share prices

Leaner and Fitter

The compensation culture in the run-up to 2008 penalised low-risk and long-term sustainability in favour of high-risk short-termism. A lack of shareholder pressure added to this: today's shareholders, with no interest in the company other than short-term gains, behave very differently from those focused on the long-term health of the company in question.

Meanwhile the lack of competition in the banking sector creates complacency. UK banks run wider margins than their continental competitors, charging 1% more to borrowers and paying 1% less to depositors. UK banks can do this primarily because customers have little choice – there are just six independent retail bank groups in the UK, compared to many thousands in the US. But can UK banks meet the challenge of becoming leaner and fitter? When Andrea Leadsom MP put this to Andrew Bailey of the Bank of England, Bailey avoided response. That might have pleased the UK banks he is supposed to be regulating, but it does not auger well for the City.³⁵

The City already runs a number of low-margin, high-volume businesses, and that model should be secure for the future. Of course, that should not be the only model. Most branded consumer markets offer a range of choice from low-cost utility products to high-value luxuries. While the price of luxury drinks or clothes brands often cannot be justified in terms of their cost, discerning or fashion-conscious customers still choose to buy them. In financial services, mergers and acquisition activity is comparable: some firms are prepared to pay premiums to get the services of their chosen advisers. There is nothing wrong with that outcome.

Regulation Cost-Effectiveness

Excessive regulation is a major contributor to cost – not only the cost of the regulators themselves (recharged to the City) but also of the legions of compliance officers and others within City businesses who have to deal with those regulators. And the burden keeps growing.

The burden is compounded by a further set of compliance agencies, namely the audit profession. Yet given the scale of banking malfeasance and the inability of internal and external auditors to detect any of it, the extent to which the audit professional seem to have escaped any blame is remarkable.

It is time now for both teams of compliance personnel to be combined. We need one set but not two.

The UK should now give a lead to the EU and the world by transforming box ticking into intelligent supervision by relatively few people. The Bank of

³⁵ Bailey is Managing Director of the Prudential Business Unit, with responsibility for the prudential supervision of banks, investment banks and insurance companies. Evidence at Treasury Committee, 15th January 2013.

England managed that for two hundred years before Gordon Brown's changes – and it can do so again, particularly under its new Governor.

The FCA can be eliminated. The few necessary functions it fulfils can be transferred to the FOS, which in turn can be strengthened and streamlined by increasing the penalties for bogus claims and the banks' rejection of customers' valid claims.³⁶

If eliminating the FCA is a step too far in the short term, at least its attention should be shifted from insisting that the financial sector provides consumers with what the FCA thinks they should have, and the standardisation, reduction in competition and erosion of choice that this implies. As the House of Commons Treasury Committee put it: "Many customers of the financial services sector have been as poorly served by regulators as by firms in recent years. We have repeatedly stressed the need for regulators to focus on competition and choice in financial services as a powerful tool to improve consumer outcomes. We welcome Mr Griffith-Jones's commitment to us that he will act as the champion within the FCA of its competition objective. However, on its own this welcome commitment by the FCA's part-time, non-executive Chair is unlikely to be enough, particularly since its predecessor the FSA has appeared to pay insufficient attention to its requirement to have regard to the need to minimise the adverse effects on competition from the discharge of its functions. *Mr Griffith-Jones will need to ensure, and demonstrate to Parliament, that the executive leadership of the FCA shares his commitment to the organisation's new competition objective.*"³⁷

Global Regulation

The City, and as a result the UK economy and its citizens, will prosper best in a globalised financial services market with only the necessary, minimum, set of regulations and external and internal regulators.

As indicated above, a simple set of eight rules are now proposed:

- a. Not excluding those who wish to compete.
- b. Ensuring that the consumer has real and substantive choice.
- c. Not fixing prices with competitors.
- d. Not laundering money.
- e. Not trading outside the permitted hours.
- f. Consumers should have access to the necessary information to make a choice.
- g. Providing redress for product failure.
- h. Cooperating with the media so that product failures and transgressions of these rules become public knowledge.

Regulations should be set for the global market, not separately for the EU or member states. The ideal of a single global market with a single set of rules or

³⁶ "Strangled at birth: Why the Financial Conduct Authority is not fit for purpose," Adam Smith Institute Report, Tim Ambler, 29th October 2012.

³⁷ Treasury Select Committee's report endorsing the appointment of John Griffith-Jones as Chair-designate of the Financial Conduct Authority, 18th January 2013.

principles can be pursued by negotiation or downward competition akin to tax competition

Competition and Choice

Consumers should be given real choices. Government guarantees for depositors, for example, should be replaced by ATOL-type insurance by the Bank of England, which individual banks can elect to offer (or not offer). The annual premium costs to participating banks would vary according to their capital and liquidity ratios and other stability data that is available to the Bank of England as regulator. This would remove the current, possibly illegal, subsidy of bank deposits by national governments and would need agreement by the EU.

Since the crash, the number of banks and building societies has shrunk. Simplifying regulation would make it easier for new financial services companies to enter the market.

Greater competition would also address the 'too big to fail' problem. In other words, even big companies could fail if depositors were protected. Normal competition rules should prevent any business from being too dominant. In addition, if UK subsidiaries were made independent on the lines of the Santander model, then the failure of a business in a host country (the UK in this case) would not bring down the parent in the home country, and vice versa.

Brand Marketing

More importantly, turning management towards the market place would itself stimulate the City. Regulation stifles experimentation, innovation and the entry of new businesses. The Coalition constantly calls for deregulation; this is an opportunity to do it.

Finally, we need to recognise that professional brand marketing provides far better consumer protection than regulation. Regulation, by trying to standardise everything, actually drives out the brand marketing needed to communicate choice and drive innovation.

At the same time, as noted above, successful branding depends on the quality of the underlying product. That is precisely why sensible management seeks to please its consumers at the same time as its own reputation through assiduous quality control. When this fails, as it did with Tylenol in the US in 1982 or Perrier in 1990 or Findus in 2013, reputation will only be recovered if the public is impressed by management's transparency and readiness to rectify the failure.

In other words, if management has enough skin in the quality game, you do not need a regulator.

Conclusion

The UK needs to put its own house in order before it can effectively persuade other countries on the two roads to a competitive global market for financial services. But the evidence of an example in simultaneously reducing but improving regulation and supervision will be important for others.

In all this, whether the UK stays in or opts out of the EU may not prove to be a big issue for the City – certainly not if a Swiss-style relationship with the EU is available. When trading in the EU, the City will have to comply with EU regulations, and the EU and UK regulations are unlikely to be very different. When trading with the rest of the world, being outside the EU might give the City more freedom. But that freedom would have to be offset against not having a place at the Brussels table when the rules are set.

Which takes the back to its conclusion: it would be much best for the City if global financial services rules were set globally and Brussels simply matched them. London needs to help the EU to understand that having a more restrictive code is not just bad for the City but even worse for the EU as a whole. Less, but more global regulation would be better for everyone.