LABOUR'S PLAN FOR BANKING REFORM

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Executive Summary

The performance of the banking sector is vital to the health of the UK economy. The finance and insurance sector makes up around 8 per cent of the UK economy and employs over one million people carrying out essential roles working with businesses and consumers to manage their money, ensuring that they are able to invest, make profits, and plan for the future. It is a global industry in which the UK plays a leading role, and financial services alone make up more than 9 per cent of UK exports.

The most important role for the banking system should be to serve our businesses, providing the funding they need to start up and grow. This is essential if we are to build a productive economy, with businesses investing for the long-term and creating the secure, well-paid and high-skilled jobs we need. Small businesses in particular rely on bank finance, and should be able to trust the banks to understand their needs and act in their best interests and without this we will be unable to raise living standards. We need a One Nation banking system that serves Britain, rather than having Britain serving our banks.

Since the global financial crisis there have been important regulatory reforms to our banking system, both at an international and UK level. In the UK, the Independent Commission on Banking, chaired by Sir John Vickers, produced a wide-ranging and authoritative report with recommendations to create a more stable and competitive banking system. The Parliamentary Commission on Banking Standards also examined how the culture of the banking sector should be reformed, following the Libor scandal. These have led to important reforms, such as the introduction of a ring-fence between investment and retail banking, which Labour supports. The global nature of banking, highlighted by the transfer of systemic risk between countries during the financial crisis, has meant that co-ordinated action has been required at an international as well as domestic level, for example through the International Regulatory Framework for Banks (Basel III) and the Capital Requirements Directive IV. That is why it is essential that the UK secure an influential place at the heart of a reformed EU rather than drifting towards the exit.

However, the implementation of the recommendations produced by those reports has too often fallen short. For example, the problems caused by the concentration of the banking sector and lack of competition in some key markets have still not been properly tackled. The Government has also failed to implement the institutional reform we need around access to finance, such as the setting up of a proper British Investment Bank.

The result is that the banking system is not trusted to act in the interests of their customers and provide the long-term support needed by businesses. The system must be stable, so that it can withstand economic shocks without falling back on the taxpayer. But stability must not be an excuse to stifle innovation or new entrants. The sector must also be competitive so that it is focused on the needs of other businesses and consumers. Only then will businesses and households be able to access the finance that they need to invest and grow. And all of these aims can only be achieved with a change of culture in the banking sector, with banks focused on service and investment not on exploitation and rapidly rising pay at the top.

This paper sets out Labour's plans for reforming the banking sector to achieve these aims. It can only be delivered by working with consumers, businesses and the sector itself. The Labour Party is therefore inviting comments and feedback on the implementation of the agenda set out in this paper.

Chapter one sets out the need for a stable sector to underpin long-term investment. The Independent Commission on Banking set out important reforms, which Labour have supported and helped deliver, such as the ring-fence between retail and investment banking. However, there is further to go on areas such as better linking pay to long-term performance and ensuring that there are clear lines of regulatory responsibility.

Chapter two sets out how a Labour Government will tackle the lack of competition in the sector, which has been clearly identified by the Independent Commission and Parliamentary Commission, the Competition & Markets Authority and others as a long-standing problem, but one which has gone unaddressed.

Chapter three describes how both businesses and households are struggling to access affordable finance. The long-standing difficulty which small and growing businesses have had with accessing credit has made the case for a proper British Investment Bank overwhelming.

Chapter four examines how the culture of the banking sector needs to change further to deliver the whole package of reforms. The financial crisis and the revelation of tax avoidance and mis-selling scandals have undermined trust in the sector and there is still some way to go before that is restored. Some of the reforms which Labour has been arguing for have been implemented, but further progress is needed on reforming the bonus culture. There is still little discernible link between pay and performance, with bonuses growing rapidly while lending to small businesses is falling.

Summary of Key Reforms

Stability

- Ensure that bankers are not rewarded for poor decisions by linking pay with long-term performance and extending clawback of bonuses to at least 10 years and consider the clawback of pay, as raised by Bank of England Governor Mark Carney.
- Return RBS and Lloyds to the private sector in a transparent way that avoids conflicts of interest and use the money from the sale to pay down the national debt.
- Clamp down on tax avoidance by closing loopholes used by Hedge Funds to avoid paying Stamp Duty Reserve Tax.
- Introduce periodic reviews of the leverage ratio taking into account bank performances in the Bank of England's stress test.

Competition

- Support the Competition and Markets Authority inquiry which we called for.
- At least two new challenger banks to address the lack of competition in the sector and a market share test to ensure the market stays competitive for the long term.
- Work with the new payment systems regulator to find ways to widen access to the UK payments system to facilitate greater competition in the current account market.
- Review the effectiveness of the Seven-day switching service and consider the introduction of a new Central Credit Register.

Access to Finance

- Create a proper British Investment Bank to support regional banking and provide vital funding for small and medium-sized businesses.
- Instil a new culture of co-operative entrepreneurship in the UK, with a growing co-operative, mutual and employee owned sector.
- Extend the levy on the profits of payday lenders to raise funding for alternative credit providers.
- Introduce a requirement for all mortgage lenders to send annual updates to customers informing them of how their repayments will change if interest rates increase.

Culture and pay

- Introduce a one-off tax on bankers' bonuses to help pay for Labour's Compulsory Jobs Guarantee – a paid starter job for all young people out of work for 12 months or more.
- Increase transparency by enacting legislation, passed by the last Labour Government, to require banks to publish the number of employees earning more than £1 million.
- Introduce a legally enforced Code of Conduct for bankers so that those who act recklessly can be struck off.

- Tackle fraud and market manipulation through an Economic Crime Bill and examine ways to firm-up the UK's penalties regime for White Collar Crime.

Chapter 1: Stability

1.1 The banking sector plays a vital role in the UK economy – both directly and through providing services for other businesses and consumers. That means that it must be stable and focused on the long-term. As the global financial crisis showed, the dislocation of the banking sector undermines the whole economy, hitting output and the public finances. Labour in Government should have been tougher in its regulation of the banks and will create a more stable banking system.

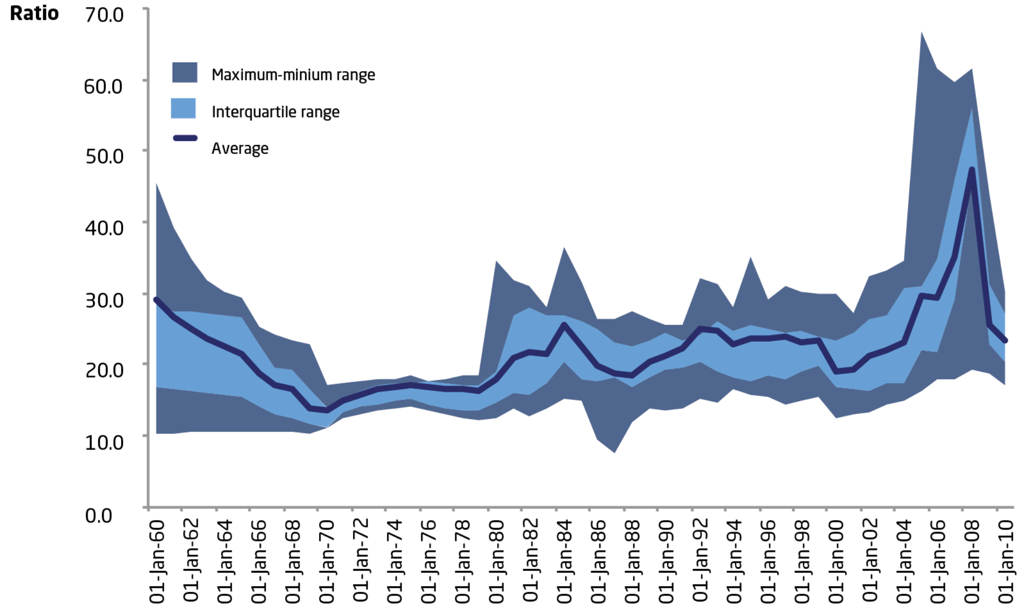
1.2 Labour has supported the thrust of regulatory reforms since the global financial crisis, but there is still further to go. Financial incentives for bank employees need to be better linked to the long-term stability and performance of their bank. The regulatory system overseen by the Bank of England needs to be strengthened and clarified. The banks currently under public ownership also need to return to the private sector, with any profits used to pay down the deficit.

The Impact of the Global Financial Crisis

1.3 The financial crisis exposed fundamental flaws in the global financial system. Excessive and ill-understood risks were taken before 2007 across the banking system, with banks operating with too little capital and inadequate liquidity and risks being transferred across national boundaries. As the Independent Commission on Banking made clear, the crisis was global, but the UK, with its large financial system, was badly affected. The recession caused by the crisis hit the public finances in the UK hard with banks having to be bailed out and revenues from the sector and wider economy falling sharply.

1.4 The Independent Commission on Banking showed that when the global crisis hit, banks were unable to absorb losses and the complexity of institutions made it impossible to sort out which parts of them should fail and which should continue. In the UK, it meant the taxpayer having to support the banking sector, including in the cases of the Royal Bank of Scotland and Lloyds Banking Group with direct injections of taxpayer money. This situation has been described as banks being too big – or too important – to fail. The stability which is needed by other businesses and consumers from their banking system will only be delivered if banks are robust to future shocks.

Figure 1: UK banks' leverage



Source: Bank of England, Financial Stability Report, June 2011

1.5 When banks are too important to fail, it ultimately means that they are benefiting from an implicit taxpayer subsidy. The value of this subsidy has been estimated by the IMF to be as much as $110 billion.[1] It means that creditors are more willing to provide funding without paying sufficient attention to a bank's risk-profile, encouraging higher leverage ratios and greater risk-taking. It gives larger banks a competitive advantage because they are more easily able to attract creditors. Most importantly, it inexorably leads to real taxpayer bailouts. The Bank of England Governor Mark Carney has called it a "heads-I-win-tails-you-lose bubble."[2]

1.6 Labour supports the proposals put forward by the Independent Commission on Banking for a tough ring-fence between investment and retail banking, higher equity requirements, and other measures to improve loss absorbency. During the course of the Financial Services (Banking Reform) Act, Labour achieved the toughening up of the ring-fence, following the report and recommendations of the Parliamentary Commission on Banking Standards. The ring-fence will isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers, ensuring that those activities are not threatened by activities that are incidental to it and that they can continue in the event of the bank's failure without government solvency support. This approach also needs to be backed up by a system of regulation – both for the system as a whole and for individual institutions – which has clear lines of responsibility and co-ordination between the different regulatory bodies involved.

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[1] International Monetary Fund, Global Stability Report, April 2014, http://www.imf.org/External/Pubs/FT/GFSR/2014/01/pdf/text.pdf

[2] Mark Carney, Inclusive Capitalism, Creating a Sense of the Systemic, May 2014, http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech731.pdf

1.7 The global nature of the banking and finance sector means that co-ordination at an international level is also vital. As Mark Carney, Chair of the Financial Stability Board (FSB), reported to the G20 leaders, while measures have been agreed "to fix the fault lines that caused the crisis", focus must now shift to account for "new and constantly evolving risks", particularly those arising from the shadow banking sector and the derivatives market. He also noted that "further work remains to build a truly resilient system".[3] Structural and regulatory reforms to the sector will only bring stability if it is matched by the right incentives for, and behaviour of, those working in the sector. One of the causes of the global financial crisis was that those who were running the banks did not, in most cases, have to deal with the catastrophic consequences of some of their mistakes. Large rewards were paid out for what turned out to be, over the subsequent years, huge failure. In the words of the Parliamentary Commission on Banking Standards, remuneration "lacked down-side incentives in the worst case scenarios that were remotely comparable to the upside incentives when things seemed to be going well". This both undermined the stability of the sector and fuelled public anger with the banking sector.

1.8 Sir George Cox, in his independent report for the Labour party on *Overcoming short-termism within British Business,* said that long-term incentives should be incorporated in executive pay across the economy.[4] The Parliamentary Commission on Banking Standards reached the same conclusion and said that that the misalignment of the annual rewards of senior bankers and the long-term interests of the firm was a fundamental flaw. As they said, deferral for two or three years is likely to be insufficient to take account of the timescale over which many problems manifest themselves in banking.

1.9 Proposals by the PRA and FCA that a substantial proportion of variable remuneration should be deferred for longer have now been implemented. This means that bonuses awarded after 1 January 2015 can be cancelled if decisions made by material risk-takers and senior managers in a bank turn out to have been responsible for significant failings. Senior managers are now subject to a deferral period of no less than 7 years, and material risk takers are subject to a deferral period of 5 years. [5]

1.10 The proposed changes to the Remuneration Code by the PRA and FCA also include clawback provisions – allowing bonuses which have already been paid out to be clawed back under specific circumstances. Variable remuneration (both deferred and undeferred) is subject to clawback for a period of 7 years from the date of award.[6] Bank of England Governor Mark Carney has raised the prospect of clawback provisions being extended to cover fixed pay as well as variable pay, arguing that this could help to restore the link between pay and performance. His comments followed the record fines levied on banks for Forex manipulation, and the

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[3] Financial Stability Board, November 2014, http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair%E2%80%99s-Letter-to-G20-Leaders-on-Financial-Reforms-Completing-the-Job-and-Looking-Ahead.pdf
[4] Sir George Cox, Overcoming Short-termism within British Business, The key to sustained economic growth, February 2013. http://www.yourbritain.org.uk/uploads/editor/files/Overcoming_Short-termism.pdf
[5] Prudential Regulation Authority, Strengthening the Alignment of Risk and Reward: New Remuneration Rules, July 2014, http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1514.pdf
[6] Bank of England Policy Statement, Clawback, July 2014, http://www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps714.pdf

attempts by some banks to circumvent the new EU cap on bonuses by establishing a new class of fixed pay called "Role Based Pay" (RBP – also known as "allowances").[7]

The Government's Watering Down of Reforms

Regulatory Reform & the Ring Fence

1.11 The recommendations of the Independent Commission on Banking Standards, partly legislated through the Financial Service (Banking Reform) Act 2012, were an important step towards a more stable banking system, but the Government has been reticent in fully implementing the necessary changes.

1.12 Following the recommendation of a ring-fence between retail and investment banking by the Independent Commission on Banking Standards, Labour proposed powers to fully split retail from investment banks unless the letter and spirit of the Commission's recommendations are fully introduced and there is cultural change in the banking sector. The Parliamentary Commission on Banking Standards then concluded in 2012 that the ring-fence should be "electrified" through the power to fully separate retail from investment banking if the ring-fence started to be eroded.[8] After initially opposing this approach the Government agreed to bring forward legislative powers for the full separation of individual institutions to take place. However, they still refused to legislate for the back-stop power allowing full separation. Labour will legislate for such a power.

1.13 The Parliamentary Commission on Banking Standards also called for the Government to relinquish political control over setting the leverage ratio. A bank's leverage ratio is vitally important to ensuring that it has sufficient capital to cover a depreciation of its assets, meet its financial obligations and absorb shocks.

The Role of Regulatory Authorities

1.14 Effective regulation is crucial to promoting responsible practice. The Financial Services Act 2012 abolished the tripartite system of regulation and replaced it with the Financial Conduct Authority and Prudential Regulation Authority, operating under the aegis of the Bank of England. We support the move to prudential regulation but significant questions remain about the role of the Bank of England as a regulator and whether sufficient checks and balances are in place.

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[7] Financial Times, November 2014, http://www.ft.com/cms/s/0/0ec9b834-6e37-11e4-afe5-00144feabdc0.html#axzz3Q2Sd3yaw

[8] Parliamentary Commission on Banking Standards (PCBS) June 2013, http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/98/98.pdf

1.15 First, much greater accountability is needed so that the new and more complex arrangements within the Bank of England can function effectively. The increases in house prices, and particularly the rapid rises in London, have recently put pressure on the current system. There was debate about whether HM Treasury or the Bank of England has responsibility and tools for preventing the development of a bubble in asset prices, and about the interaction between the Monetary Policy Committee (MPC) and the Financial Policy Committee (FPC). The tools available to the two committees – to set interest rates and intervene to address systematic risks through macroprudential regulation – are clearly related. The sequencing of interventions by both committees is crucial in providing a stable financial system. The Governor's role would also be helped by greater transparency and clarity, and the Treasury Select Committee have rightly raised concerns about the lack of checks and balances and scrutiny.

1.16 Second, the division of responsibility for implementing and policing European regulations at a domestic level already seems unnecessarily complex. For example, the domestic regulatory oversight of Basel III CRDIV is fragmented, with responsibility carved up between different regulators. This division of functions has the potential to lead to considerable confusion, especially where there is inadequate communication and sequencing. We will therefore investigate ways of simplifying and streamlining the implementation of European regulations and ensure that the UK is influential at the heart of EU negotiations.

1.17 Third, there is confusion at the heart of the Government's reforms about responsibilities in the run-up to and during a financial crisis. The reforms mean that the Governor of the Bank of England – when dealing with the Chancellor of the Exchequer – will now be able to internalise and suppress the inevitable conflicts between financial stability on the one hand, and monetary stability, fiscal risk and moral hazard on the other. It makes no sense that the deputy Governor, who heads the prudential regulator, has no undisputed right to put his views direct to the Chancellor, whether or not the Governor agrees. This is neither stable nor sensible.

1.18 Finally, it is not clear how the Bank of England's "ad hoc committees" will function in a crisis, adding to the sense that much of the new wiring between the Bank and the Treasury has not been properly thought through. This needs to be addressed.

Removing the Burden from the Taxpayer

1.19 The process of returning RBS and Lloyds to the private sector has been undermined by the Government's wider economic failure. While well-functioning banks are vital to the wider economic health of the UK, the reverse is also true. The decisions taken by the Government in 2010 which held back growth in the UK, and led to the longest fall in real wages since the 1870s, made it more difficult for the banks rescued by the taxpayer to return to the private sector.

1.20 The share price of RBS is still below the level required for taxpayers to make their money back and, while progress at Lloyds has been greater, and there has been welcome progress in the divestment of TSB, there is still some way to go before a full return to the private sector. The mistakes made by the Government in the privatisation of Royal Mail, with a loss to the taxpayer of £750 million on the first day of trading according to the National Audit Office, have illustrated key failings in the Government's approach to flotations. These failings must not be repeated.

Labour's Plan for Reform

Long-term Pay

1.21 Labour believes that longer-term pay incentives, which more closely align the reward for individuals with the performance of their bank over the business cycle, would lead to a more stable system. The proposals made by the PRA and FCA to extend deferral periods for variable pay and a clawback period are a step in the right direction. However, they do not go far enough. As the financial crisis and recent scandals have shown, risky decisions can take up to a decade to have an impact. The deferral period for senior managers should be 10 years (in line with the recommendations of the Parliamentary Commission on Banking Standards). Clawback should also be extended to at least 10 years after bonuses are awarded.

Role of the Bank of England

1.22 The Government's reforms to the role of the Bank of England have left confusion about responsibilities in the event of a financial crisis and a lack of clarity about objectives. There is too much scope for a lack of co-ordination in decisions about monetary policy and financial stability, and even directly contradictory action by the Monetary and Financial Policy Committees. The work of these Committees should be better integrated.

1.23 In a crisis situation**,** the memorandum of understanding between the Bank of England Governor and Chancellor should be specific as to how the Stability Committee works. The rules of engagement between the Bank, Treasury and Committee should be clearly defined and delineated in advance.

1.24 The sole line of communication should not be through the Chancellor and the Governor of the Bank of England. A Labour Government would introduce periodic meetings between the Chancellor and the heads of all the regulatory authorities to ensure that any issues are reported clearly and quickly.

1.25 In addition to this, and following the recommendations of the Treasury Select Committee, we would require the FCA and PRA to publish minutes of all their board meetings, to be freely accessible to members of the public.

Transition of state-owned banks into private ownership

1.26 The return of RBS and Lloyds to the private sector must maximise the return to the taxpayer and ensure that the institutions returning to the private sector are stable and competitive.

Labour would implement processes to achieve this which are transparent, and which learn lessons from the failures of the Royal Mail privatisation with a clear delineation between preferred investors and the companies who are selecting the preferred investors. The proceeds of the sale will be used to pay down the national debt.

Taxing Transactions

1.27 A Financial Transactions Tax has been put forward as a way of reducing instability in the financial system by increasing the cost of carrying out high-frequency trading. The UK already has a Financial Transactions Tax – Stamp Duty Reserve Tax – which raises around £3 billion each year and a number of other EU countries are currently designing and implementing a similar tax. Labour supports moves towards a global Financial Transactions Tax which includes the major financial centres.

1.28 There is also evidence of widespread avoidance of Stamp Duty Reserve Tax by hedge funds through the use of intermediaries who have relief and the use of Credit Default Swaps. Labour will clamp down on this tax avoidance.

Leverage Ratio

1.29 There is a need for clarity and accountability in the manner and level at which the leverage ratio is set. The Treasury should set a target for the leverage ratio, which would then be supervised by the Financial Policy Committee to ensure banks are safe. The level of the ratio would be periodically reviewed on an industry wide basis and, where necessary – for example, where a bank fails the Bank of England's stress test – an individual basis. The impact on different business models, such as building societies, would also be considered.

Chapter 2: Competition

2.1 Competition in the banking market is vital for ensuring that small businesses and other customers can get access to credit at affordable rates, and receive a high quality of service by promoting innovation and efficiency. Without the discipline provided by competition, and the threat of customers moving quickly and easily between banks, there have also been too many cases of banks taking their customers for granted and providing poor services. In extreme but too frequent cases, there has even been exploitation of customers through mis-selling: compensation for Payment Protection Insurance has now cost the industry over £23 billion in funding set-aside, while around 40,000 small businesses were mis-sold interest rate swaps.[9]

2.2 Also, since May 2010, lending to businesses has fallen by over £55 billion and a third of businesses applying for loans are turned down.[10] A lack of competition leads to higher prices, with nearly a quarter of small businesses who want finance, but are put off applying, citing the cost of borrowing.[11] As revealed by Sir Andrew Large's report for RBS on the treatment of their small business customers, a large and sprawling bank can fail to develop vital relationships with small businesses, and become unresponsive to their customers' needs.[12]

2.3 This chapter outlines the current problems with competition in the sector, and Labour's package both to increase competition and ensure that market concentration does not return in future.

The Concentration of the UK Banking Market

2.5 The lack of competition in UK retail banking has been a long-standing problem. Over the last 30 years, the larger PLC has become the dominant business form for banking in the UK, and this lack of corporate diversity has on occasion undermined stability, risk and competition. The Bank of England has examined how the demutualisation of the building societies in the 1980s and 1990s led to concentration of the sector,[13] while in 2002 the Competition Commission said that there was significant concentration in banking services for SMEs, and that this had changed little over the previous decade.[14] Progress was made in making the sector less concentrated following the Competition Commission's review, but the mergers during the financial crisis again led to concentration as banking groups were consolidated. These mergers were necessary to stabilise the banking market, but their impact has not been addressed by the current

[9] Financial Services Authority, Interest Rate Hedging Products, March 2013,http://www.fca.org.uk/static/pubs/other/interest-rate-swaps-2013.pdf
[10] BRDC Continental, http://www.bdrc-continental.com/EasySiteWeb/GatewayLink.aspx?alId=8049
[11] BRDS Continental, http://www.bdrc-continental.com/EasySiteWeb/GatewayLink.aspx?alId=8049.
[12] Independent Lending Review, http://www.independentlendingreview.co.uk/index.htm
[13] Bank of England, http://www.bankofengland.co.uk/publications/Documents/fsr/2004/fsr16art9.pdf
[14] National Archives, http://webarchive.nationalarchives.gov.uk/+/http://www.competition-commission.org.uk/press_rel/archive/2002/mar/html/15-02.htm

Government.[15] And while the assets of the major UK banks have fallen slightly in recent years, they still remain considerably above pre-recession levels.[16]

2.6 The report of the Independent Commission on Banking, chaired by Sir John Vickers, examined the concentration of different parts of the banking market. The financial crisis caused a market which was already concentrated – particularly in SME banking and personal current accounts – to become even more so. The Commission also found that although some countries have national banking systems which are as concentrated as the UK's (for example, Netherlands, Sweden, Australia and Canada), their smaller populations mean that economies of scale make concentration more justifiable, while better comparators (Germany and France) have much more developed regional banking structures making direct comparisons difficult. They also pointed out that the US is making some attempt to tackle concentration through the Dodd-Frank reforms (see box 1).[17]

Box 1: The Dodd-Frank Reforms in the United States

The Dodd-Frank reforms in the US addressed concentration in financial services in the US, prohibiting a financial company from merging with or acquiring another firm if the result is a company with over 10 per cent of the 'aggregated consolidated liabilities' of all firms in the domestic market. It is for the Board of the Federal Reserve to issue the regulations implementing this section, including the rules on how consolidated liabilities are to be measured.

There are significant differences between the US banking market and that in the UK. In the US there is a more diverse range of banks at a national level and greater concentration at a state level, especially in areas with low population density. But while the mechanism for setting a cap, the way in which it operates, and the level at which it is set need to be different in the UK, lessons can still be drawn.

2.7 The Commission concluded that there is a long-standing problem with competition in banking, especially in markets for personal current accounts (PCAs) and banking services for small and medium-sized enterprises (SMEs).[18] They concluded that strong and effective challenger banks would much improve the prospects for competition.[19] The Parliamentary Commission on Banking Standards agreed with these conclusions, adding "greater market discipline can help address the resulting consumer detriment and lapses in standards, and buttress regulation".[20]

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[15] Vickers, Final Report, Figure 7.1

[16] IMF, Global Stability Report, April 2014

[17] Vickers, Final Report, para 7.15

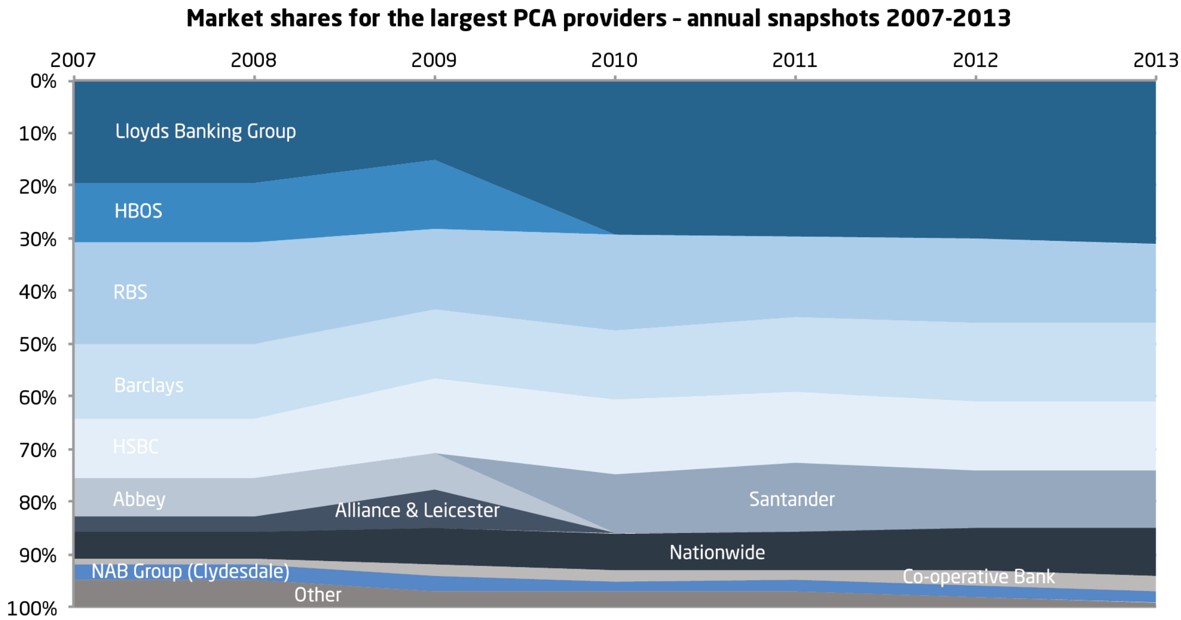
[18] Vickers, Final Report, para 6.7

[19] Vickers, Final Report, para 8.30

[20] Parliamentary Commission on Banking Standards (PCBS) June 2013, http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27.pdf; page 11

2.8 The scale of the challenge has also been uncovered by market studies into retail banking begun by the Office for Fair Trading (OFT) and completed by the Competition & Markets Authority (CMA). The CMA's PCA market study update, published in July 2014, found that the four major banks (Lloyds banking group, RBS, HSBC and Barclays) controlled 77.2 per cent of the market in December 2013.[21] Figure 2 shows the concentration of the market for Personal Current Accounts. TSB has now also entered the market, but only holds between 4 and 5 per cent of the market share.

Figure 2: Market shares for the largest PCA providers



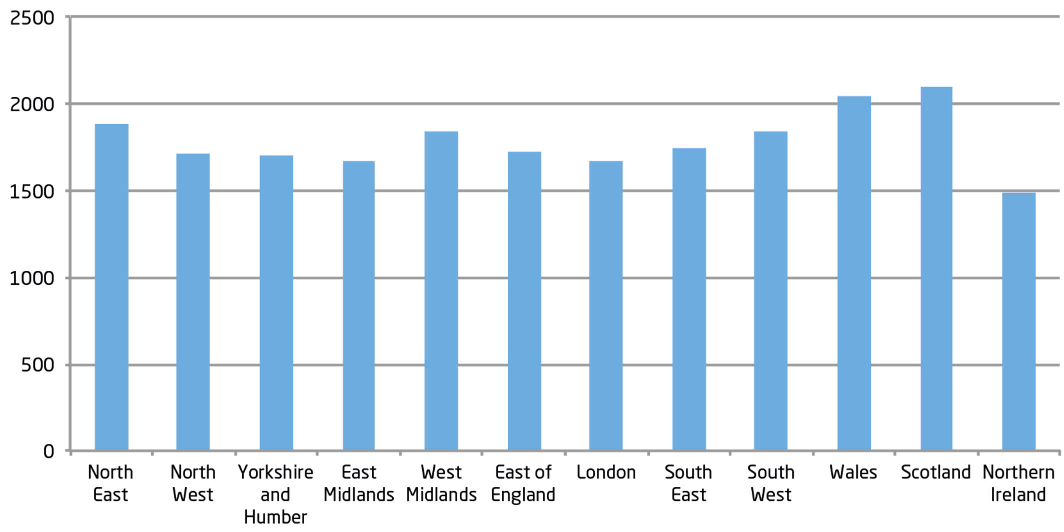
2.9 The CMA's market study of banking services to small and medium-sized enterprises found that the four largest providers of Business Current Accounts (BCAs) provide 85 per cent of BCAs in England and Wales, with the sectors in Scotland and Northern Ireland being even more concentrated. They found that:

- New entry has been limited and there are still high barriers to entry and expansion for newer and smaller banks;
- SME customers believe there to be little differentiation between providers;
- SMEs have difficulty comparing offers across providers and demonstrate low levels of shopping around;
- The banks with lower customer satisfaction levels have high market shares and are not losing significant market share – while those with the highest customer satisfaction are not able to expand.[22]

[21] https://assets.digital.cabinet-office.gov.uk/media/53c834c640f0b610aa000009/140717_-_PCA_Review_Full_Report.pdf
[22] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/346931/SME-report_final.pdf

2.10 The CMA's analysis of the PCA market included a calculation of the Herfindahl-Hirschman Index (where a market is generally considered to be concentrated if it has an index value of over 1000, or highly concentrated if it is over 2000) for different parts of the UK. It found that the market was most concentrated in Scotland, which means that Labour's policies to improve competition are likely to bring most benefit to bank customers there.

Figure 3: HHI for UK Countries and Regions



2.11 In summary, the conclusion from the independent banking commissions and studies by competition authorities is that the banking sector is too concentrated and that there is a problem with competition. However, the Government has refused to take the difficult decisions needed to address these conclusions.

The Government's Failure to Deliver Competition

2.12 A key barrier to competition is that it is very difficult for new entrants or 'challengers' to set up and grow because of the necessary regulatory requirements and infrastructure. Although some new banks have been set up and other retailers are entering the banking market, such as Metro Bank, Tesco Bank, M&S Bank, Virgin Money, and the new online-only bank Atom, they are, so far, too small to provide proper challenge to the established large banks. The Competition & Markets Authority has found that since 2011, there has been very little movement in market shares and although there have been small changes these are very gradual and, at the current rate, unlikely to reduce overall levels of concentration significantly.[23]

2.13 As the Independent Commission on Banking and the Parliamentary Commission on Banking Standards argued, the divestment of branches by Lloyds and RBS should have provided an opportunity to bring significantly greater competition into the banking market. Unfortunately, it is an opportunity which has been missed. The divestment of branches by the Lloyds Banking Group to form TSB has created a bank which has the potential to become a challenger to the established banks, but it will need to grow further to reach the size judged by the Independent Commission on Banking as sufficient for it to be an effective challenger. The RBS divestment to form Williams and Glyn should also introduce another bank into the vital market for small businesses, but is now not expected to be complete until the end of 2017. The risk is that the Parliamentary Commission on Banking Standards are correct in their conclusion that both divestments have failed and that it looks increasingly unlikely that a significant new challenger bank will soon emerge from them.[24] The OFT have already said that the divestments will only have a limited impact on overall structure in PCAs and SME banking with their market shares being below the 5 per cent threshold identified by the OFT.[25]

2.14 Competition in key banking markets such as Personal Current Accounts and Small Business lending is not only held back by the concentration of the sector. Competition also requires customers to be able to switch quickly and easily between banks, and for banks to be able to accurately assess the needs of their customers.

2.15 However, switching between banks remains low. The standardised switching service introduced in September 2013, which commits banks to completing the process in seven days and providing a redirection service, was a step in the right direction.[26] However, it has not had a transformative effect and the CMA's market study of banking services to SMEs found that SME take up of the service is low, with only 7,330 SMEs switching using the service in the six months to March 2014 – a very small proportion given that there are over 3.5 million holders of Business Current Accounts.[27]

2.16 New rules are also being devised for the sharing of data on Small & Medium Sized Enterprises (SMEs), which would require banks to share SME credit data through credit reference agencies, making it easier for alternative finance providers – such as challenger banks - to check the credit-worthiness of potential business customers. But while welcome, such reforms are again not going to have a transformative effect on the service provided to small businesses.

[23] Competition and Markets Authority, Personal Current Accounts Market Study update, July 2014 https://assets.digital.cabinet-office.gov.uk/media/53c834c640f0b610aa000009/140717_-_PCA_Review_Full_Report.pdf

[24] Parliamentary Commission on Banking Standards (PCBS) June 2013, http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/27.pdf; page 29

[25] Letter from Office of Fair Trading Chief Executive, Clive Maxwell, to George Osborne, Chancellor of the Exchequer, 11 September 2013, http://www.oft.gov.uk/shared_oft/financial/letter.pdf

[26] Payments Council, http://www.paymentscouncil.org.uk/switch_service/current_account_switch_guarantee/

[27] https://assets.digital.cabinet-office.gov.uk/media/53eb6b73ed915d188800000c/140813_SME_report.pdf

2.17 A more effective reform would be a Central Credit Register for SMEs, as examined by the Bank of England.[28] This would allow challenger banks and other credit providers to more easily assess the creditworthiness of small businesses, make it more straightforward for them to enter the market, and therefore increase competition. The Treasury themselves have said that such a register could be transformative, supporting the emergence of new lenders with business models that make greater use of borrower information and rely less heavily on collateral.

Labour's Plan for Reform

2.18 As this chapter has set out, the lack of competition in the banking sector has been well established by a range of authoritative studies. However, the current Government's banking reforms have failed to address the problem and to help small businesses and consumers get the support they need. It is now clear that decisive measures are needed to break the deadlock and make progress.

2.19 We welcome the Competition and Markets Authority inquiry into competition in the banking sector, which we called for, and want to see at least two new effective challenger banks enter the market. New challenger banks will need to have a market share greater than the level recommended by the Office for Fair Trading for a challenger (five per cent of market share) in the key banking markets of Personal Current Accounts and Small Business Lending.

2.20 Labour will continue to assess the effectiveness of the Seven Day Switching Service, and if it does not bring about a sustained increase in switching rates will consider more radical options, particularly for SMEs, including the delivery of a Central Credit Register, drawing on the analysis of the Bank of England and others.

2.21 A competitive banking system will also require reform of the UK Payments system, which is the means by which financial transactions are processed. The creation of the Payments System Regulator and its aim to reform governance, ownership and access to the system is welcome. Labour will work with the new regulator to deliver on these ambitions because widening fair access to the UK payments system is key to enabling greater competition into the current account market. This will make it easier for new and smaller financial institutions, such as new challenger banks or credit unions, to offer current accounts and reduce barriers to entry in the marketplace. But competition will only be embedded for the long term if there are mechanisms in place which prevent the return of concentration and ensure that future governments and regulators are not able to duck the challenge.

2.22 Labour will therefore work with the competition authorities to put in place a market share test for the banks that ensures the market stays competitive for the long term. In order to put in place a market share test, Labour will ask the Competition & Markets Authority, as part of their ongoing investigations into key retail banking markets, to advise within the first six months

[28] Bank of England, should the Availability of UK Credit Data be Improved, May 2014
http://www.bankofengland.co.uk/publications/Documents/news/2014/dp300514.pdf

of a Labour Government on how steps to improve competition can be implemented. Key issues to be determined in this process are:

- How much the market share of the big banks should be reduced;
- The timetable for that reduction, so that they are fully in place within the Parliament;
- The level of a maximum threshold for market shares in future, which would trigger another market investigation if breached.

Changes will be judged against three key criteria. The changes must:

- Create at least two new challenger banks with market shares which mean they can compete effectively.
- Create a level of competition which will improve the price and quantity of lending to small businesses;
- Create a level of competition which will improve customer service.

Labour will then implement the CMA's recommendations, with the full reform package to be implemented alongside the rest of Vickers' banking reforms within the course of the next Parliament.

Chapter 3: Access to Finance

3.1 The lack of competition in the banking sector adds to a long-standing problem in the UK economy with businesses – particularly small and growing businesses – unable to access the patient finance which they need to succeed. The close links between investment in growing businesses, productivity, and the high-skill, high-pay jobs which we need to raise living standards means that this structural problem must be addressed.

3.2 The cost-of-living crisis is also driving many people into debt, with high cost credit trapping them in a cycle of unaffordable loans and ever higher debts. Labour is therefore putting forward a package of reforms to tackle pay-day lenders and to support the development of alternative sources of finance.

The Lack of Access to Affordable Finance

Access to Affordable Finance for Businesses

3.3 Small firms' access to finance has been identified as an issue in the UK for many decades. As the report by Nick Tott on *The Case for a British Investment Bank*[29] showed, there is a strong case for a British Investment Bank, modelled on international best practice.

3.4 As Nick Tott's report concluded, the non-availability of finance to smaller businesses is long-standing. It was identified in 1931 by the Macmillan Report (such lack of finance being known as the 'Macmillan Gap'). Market failure is caused by an asymmetry of information between debt provider and business borrower. Lenders find it difficult to distinguish between high and low risk businesses without incurring significant costs. Lenders seek to avoid those costs by basing the decision to lend on evidence provided by the borrower as to its track record and/or the provision of collateral. This obviates the need to assess whether the business is economically viable. Despite this, the UK has been the only country in the G7 without a state-backed institution supporting small business finance on a significant scale.

3.5 Recent developments on capital requirements have only reinforced this long-standing structural problem in the UK system. Banks claim that the new capital requirements and risk-weightings which they face, which are essential for the future stability of the sector, make it more difficult for them to lend to small businesses on a medium or long-term basis.

3.6 Businesses also often report that their banks feel remote and do not understand their needs. The diminished role in decision making by local bank managers in several institutions has contributed to this and undermined the ability of banks to make informed and accurate decisions about the risk attached to small businesses. This was the conclusion of Labour's Small Business Taskforce, which examined the Sparkassen model of banking in Germany and found that "while the particular Sparkassen model may be specific to Germany, the characteristics

[29] *The Case for a British Investment Bank,* http://www.yourbritain.org.uk/uploads/editor/files/BRITISH_INVESTMENT_BANK.pdf

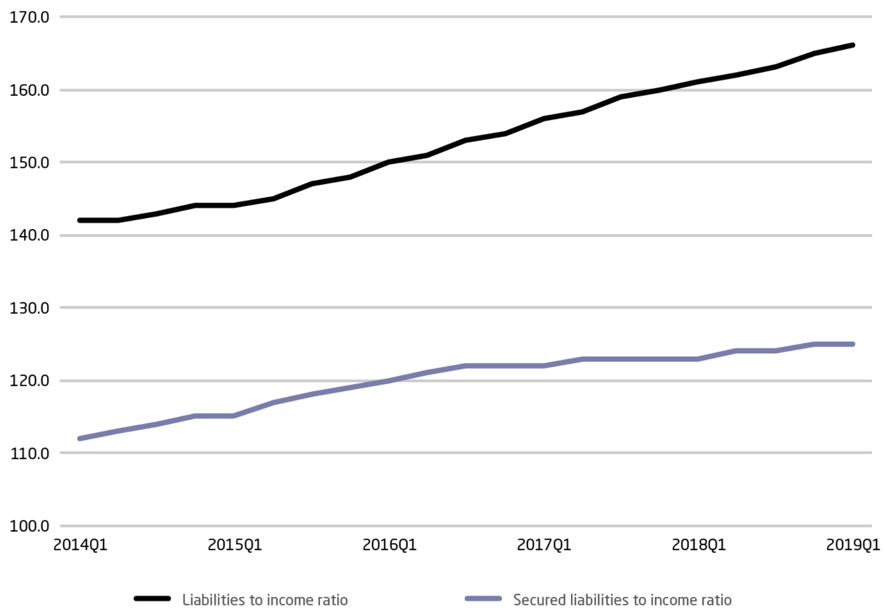
that make it successful – of genuine proximity, creating deep expertise within a geographically mandated area – is not. This can be part of the future for small business banking in the UK."[30]

Access to Affordable Finance for Households

3.7 Access to affordable finance is an issue for families as well as businesses. Too many people struggling with the cost-of-living crisis also face high housing costs and, in a growing number of cases, are being caught in the trap of high-cost credit. The rapid growth in house prices, particularly in London and the South East, means that many households are facing high housing costs even while interest rates are at historically low levels.

3.8 The OBR is forecasting that the ratio of secured liabilities (mostly mortgages) to income, and household income leverage (debt servicing costs as a share of disposable income) will rise over the next five years.

Figure 4: OBR Household Debt Forecast, March 2014 (percentage share of annual income)



Source: OBR

3.9 Many people are struggling, with 13 per cent of households spending more than 30 per cent of their income on unsecured credit repayments.[31] Short term credit is also being used to meet rising utility costs such as energy bills. A recent survey by the Financial Conduct Authority found

[30] An Enterprising Nation, Final Report of the Small Business Task Force, http://www.labouremail.org.uk/files/uploads/b6e7fa23-1132-0364-1560-7898854ed07b.pdf

[31] BIS, Credit, Debt and Financial Difficulty in Britain, 2012, June 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/208075/bis-13-p187-a-report-using-data-from-the-yougov-debttrack-survey.pdf

that 55 per cent of those with high cost short term credit said they used loans for everyday expenditure, including housing and household bills.[32]

3.10 The high cost credit market has grown rapidly in recent years. The FCA estimates that in 2013, 1.6 million customers took out around 10 million loans, with a total value of £2.5 billion. It is estimated that around three-quarters (76 per cent) of payday loan customers took out more than one loan in 2012. On average, a payday loan customer took out 6 loans in 2012, though as many as 15 per cent took out more than 10 loans.[33]

3.11 For some households, their financial situation is made worse by overdraft charges or even a lack of access to basic banking services. The new Financial Inclusion Commission is highlighting the impact of financial exclusion not just on people's finances, but on their education, employment, health, housing and overall well-being. They report that nearly 2 million adults remain unbanked in Britain, while there are 13 million people in the UK who do not have enough savings to support them for one month if they experienced a 25 per cent cut in income.[34]

3.12 Those without access to basic banking services are often on low incomes who risk paying more for utility bills because they use more expensive key meters or struggle to obtain rented accommodation (which is often paid through a standing order). Low income areas have also disproportionately borne the brunt of bank and building society branch closures.[35] As the Parliamentary Commission on Banking Standards stated, "in an increasingly cashless society, access to a transactional bank account has become crucially important."[36]

3.13 Financial education and access to basic bank accounts are crucial steps towards ending financial exclusion. Financial education needs to begin at primary school and an understanding of money and financial decisions has to be continuously developed from childhood through to and including adulthood. The current system falls some way short of this.

The Government's Failure to deliver Affordable Finance

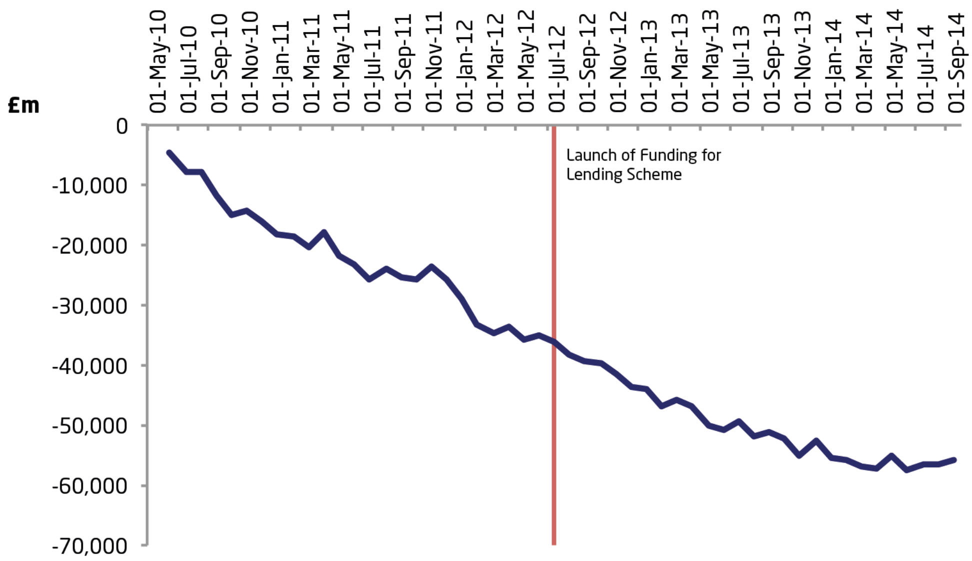
3.14 In response to Labour making the case for a British Investment Bank, the Government set up a Business Bank. However, the Government's Business Bank lacks the ambition and resources to tackle the problem. It is largely an aggregation of existing schemes, which is worthwhile but does not meet the scale of the challenge. As the British Chambers of Commerce said in response to the announcement of the Business Bank:

[32] FCA, 'Proposals for a price cap on high-cost short-term credit', July 2014, http://www.fca.org.uk/static/documents/consultation-papers/cp14-10.pdf
[33] Competition and Markets Authority, Payday lending market investigation: Provisional findings report, June 2014, https://assets.digital.cabinet-office.gov.uk/media/539b1d16e5274a103100000a/Main_report.pdf
[34] Financial Inclusion Commission, http://www.financialinclusioncommission.org.uk/facts
[35] Financial Inclusion Commission, http://www.financialinclusioncommission.org.uk/facts
[36] PCBS, 193

"it has to address the long-term structural gaps in the business finance market for it to be a game changer. That means lending directly to growing companies that have previously failed to get the growth capital they need, and building a bank on a larger scale than the current proposals suggest."[37]

3.15 Despite numerous government schemes since 2011, from Project Merlin to the Funding for Lending Scheme, net lending to SMEs, excluding overdrafts, is down by almost £2 billion in the last year while net lending to all businesses is down by over £55 billion since May 2010.[38] The latest Funding for Lending Scheme statistics showed that net lending by FLS Extension participants to SMEs fell by over £400 million in the second quarter of 2014.

Figure 5: Cumulative net lending to business, since May 2010



Source: Bank of England

3.16 On household finances, the difficulties faced by people trying to buy their own home has been exacerbated by the Government's failure on house building, which is at its lowest peacetime level since the 1920s. This makes it more difficult for young people to get on the housing ladder, and means that they have to stretch their finances further.

3.17 Labour proposed a cap on the total cost of credit in 2013 to protect people having to access short-term credit. After consistently opposing the introduction of such a cap, the Government finally changed their mind. But the Government have still failed to give local communities the

[37] British Chambers of Commerce, http://www.britishchambers.org.uk/press-office/press-releases/bcc-clarity-on-rail-franchising-will-come-as-relief-for-businesses.html

[38] Bank of England data

powers to restrict the ability of payday lenders to dominate high streets or to curtail advertising to children.

3.18 During the course of the 2012 Financial Services (Banking Reform) Act, Labour also put forward a range of proposals to help consumers access affordable credit, ensure that they are not overcharged by credit providers, and support them to make informed decisions about their finances. However, the Government have been complacent in the face of a probable rise in interest rates.

Labour's Plan for Reform

3.19 Labour will set up a proper British Investment Bank, building on the existing Business Bank, with greater resources and ambition to improve access to finance for small and medium-sized businesses. In order to provide the British Investment Bank with greater resources, all funds raised from the planned increase in the license fees for the mobile phone spectrum – estimated to be up to £1 billion in the next Parliament, subject to Ofcom consultation – will be allocated to the British Investment Bank. We will also examine how the Green Investment Bank, with its focus on investment in infrastructure, can be developed further and how it can be linked to the British Investment Bank.

3.20 Labour is also studying how international examples, such as the Small Business Administration in the US and the KfW in Germany, securitize loans provided by other institutions to small and medium-sized businesses. The British Investment Bank will learn from these models so that we can help existing and new banks provide more loans without taking on unreasonable levels of risk. This would be alongside an expansion and rationalisation of the Government's Business Bank's schemes for providing equity and debt investments.

3.21 The BIB would also play an important role in supporting the growth of private sector regional banks, harnessing local energy and demand for such institutions. Finance institutions which are rooted in their local area are increasingly being seen as an important source of funding for small businesses. Community Development Finance Institutions (CDFIs) are already operating in many regions of the UK, delivering finance at a local scale. Regional institutions on a more traditional banking model are also being established, such as those in Hampshire and Cambridge. Even larger challenger banks are seeing a regional model as the best way to establish their small business lending operation, so that it can draw on the detailed knowledge of local economies and the needs of small businesses within them.

3.22 However, much more needs to be done to encourage and support this development of regional banking. The BIB will do this by providing guarantees to regional banks, meaning that they will be able to expand their lending to small businesses while still meeting regulatory requirements. To support this regional model, the BIB will also have centres in each of the main city and county regions, whose role it would be to understand and build relationships with local businesses.

3.23 Labour will also look at establishing a simplified regulatory regime for anyone wanting to set up new regional banks, with the BIB providing advice to seeking to access the regime. This would include a system of governance which restricted lending to a region and a supervisory board drawing its membership from independent Local Enterprise Partnerships and Combined Authorities, tied in with Labour's wider devolution package supporting businesses. Labour will also examine the options for providing centralised support for some of the infrastructure which sits behind regional banks, such as collective insurance, legal and IT services.

3.24 On access to consumer credit, Labour will promote safer and more ethical forms of lending and look to instil a new culture of co-operative entrepreneurship in the UK, with a growing co-operative, mutual and employee owned sector. This will help to raise productivity and ensure that more working people are able to reap the rewards of economic success. Credit unions, co-operatives and social enterprises possess the growth prospects and inclusive ownership models necessary to make the financial sector more secure, capable and responsive (see box 2)[39].

3.25 A Labour Government will ensure co-operatives and mutual ownership models are able to compete on a level playing field and extend the levy on payday lenders to raise millions of pounds which we will use to increase the public funds for low-cost alternatives such as credit unions. Labour will also give greater powers to local authorities to limit the spread of payday lending shops in town centres, and ask the Advertising Standards Authority to prevent irresponsible advertising by payday lenders that targets or exploits children and young people. And Labour will investigate other ways to support mutuals, for example by improving the regulatory structure in which they operate and making available support from the British Investment Bank.

3.26 Families facing a cost-of-living crisis, having to take on large mortgages to get themselves on the housing ladder, also need be able to prepare for rising interest rates and repayments when the Bank of England starts to return interest rates to more normal levels. Labour will therefore bring in a requirement for all mortgage lenders to send annual updates to customers informing them of how their repayments will change if there is an increase in the interest rates. It is not sufficient for this to be done only at the start of a mortgage deal – it should be done each year so that households are informed as and when they are affected.

3.27 Labour has said that no school should be judged as good or outstanding unless it is delivering a broad and balanced curriculum and equipping young people with the skills they need. An understanding of money and financial decision-making needs to be part of that.

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[39] House of Commons Library, http://www.parliament.uk/business/publications/research/briefing-papers/SN07089/social-enterprise;
State of Social Enterprise Survey 2013, http://www.socialenterprise.org.uk/uploads/files/2013/07/the_peoples_business.pdf;
Community Development Finance Association statistics, http://www.cdfa.org.uk/about-cdfis/statistics/

3.28 Labour will also act on the recommendation of the Parliamentary Commission on Banking Standards by requiring the banking industry to agree a minimum standard for basic bank accounts, guaranteeing access to everyone who meets agreed eligibility criteria. The FCA would have responsibility for ensuring the minimum standards are upheld. Other measures will include asking the Financial Services Compensation Scheme to review the protections for customers who use pre-payment schemes for the supply of goods and services and extending the scope of the Scheme to provide increased protection for customers of a failed financial institution.

Box 2: Third Sector finance

The UK mutual sector (or "third sector" as it is sometimes known), includes credit unions, co-operatives and social enterprises. Mutuals, by definition, exist to serve their members or employees; they do not have external shareholders and are not, therefore, driven by the same financial imperatives as banks or other financial institutions. They are committed to serving the communities in which they operate and are often regionally based, bringing them closer to their customers. These factors combined enable them to extend financial services to people who may otherwise be financially excluded, offering a lifeline to those in less well-off communities or in financial hardship. However, not only do mutuals have the capacity to counter exclusion; they also have the potential to stimulate the economy, employing close to a million people and generating a combined income of £115 billion.

Credit Unions, for example, have enabled people across the country to save in, and borrow from, organisations that are genuinely rooted in their communities. There are currently around 500 Credit Unions in the UK, with over one million members. They range in size and scope from small local organisations run by volunteers which offer loans at affordable rates, to larger, regional organisations which offer a fuller range of financial products, including mortgages.

Because they do not have to produce a profit for shareholders, Credit Unions are free to serve the needs of local communities, offering a safe and sustainable alternative to other, more predatory organisations operating on the fringes of the financial system, such as payday lenders. Raising the profile of credit unions and increasing the number of members from across the socio-economic spectrum will be key to their long-term expansion.

The social enterprise sector has also grown in recent years, with its contribution to the economy estimated at about £24 billion. Social enterprises have a social purpose; they are predicated on community goals and any profits are reinvested in the venture, not paid out to investors. 38 per cent of social enterprises work in the 20 per cent most deprived areas in the UK. Community Development Finance Initiatives (CDFIs) are social enterprises which invest in communities, providing affordable finance that would otherwise not be available. By making loans, they are able to recycle this finance again and again into neighbourhoods where it is most needed.

There are currently around 60 active CDFIs operating across the UK, helping businesses start up, grow, and create jobs. Figures collected by Community Development Finance Association (CDFA) show that in the third quarter of 2014, CDFIs lent £6.4 million to businesses, individuals, homeowners and social ventures throughout the UK, and had £205 million worth of loans outstanding. This has created and safeguarded nearly 4,000 jobs.

Chapter 4: Culture & Pay

4.1 Britain has a proud and honourable tradition of banking. At its best, it serves other businesses and supports customers, acting as the backbone of the UK economy. However, the financial crisis and the subsequent revelations of tax avoidance and mis-selling scandals showed that there are deep-rooted cultural problems in the sector. While thousands of ordinary bank employees work hard to serve communities, the culture of excessive risk and exploitation of customers has spread from investment to retail banking. That is why Labour has pressed the case for a proper separation between investment and retail banks.

4.2 Many leaders in the banking sector are doing important work with their employees to change the culture of their institutions and reforms led by Labour have encouraged steps in the right direction. But too little progress has been made to rein in excessive pay and bonuses. Entrepreneurs and wealth creators should be rewarded, with exceptional rewards for exceptional performance. Too often, pay and bonuses in our banking system reward failure and are out of all proportion to the contribution being made to the success of the bank or the wider economy. It is therefore concerning that bonuses are rising again in the banking sector, despite the justified dissent from shareholders and taxpayers who are facing stagnating incomes.

4.3 This chapter summarises the overwhelming case for a change in the culture of the banking sector. It focuses on areas in which the current Government has failed to act, and which a Labour Government would move to reform.

A Culture of Exploitation Instead of Service

4.4 More than six years on from the collapse of Lehman Brothers, concerns remain that there has not been the fundamental reform of UK banking culture that is needed to ensure there is no repeat of the irresponsible behaviour that led to the Financial Crisis and tax avoidance and mis-selling scandals which have subsequently been revealed. The mis-selling of Payment Protection Insurance has led to the highest compensation payouts on record by the industry, with incentive schemes which forced staff to exploit instead of serve their customers still being uncovered. The deliberate rigging of markets for benchmarks and commodities by some traders for their own gain and to damage others rightly causes outrage and has not yet been adequately addressed.

4.5 The mis-selling of interest rate swaps to around 40,000 small and medium-sized firms has symbolised some of the worst features of the system. Thousands of small and medium-sized businesses rely on their banks for the credit and support that they need to grow. Owners of these businesses need to be able to trust their banks, so that they can work together to invest, grow and provide the productive and well-paid jobs we need to raise living standards. But in this case, thousands of such businesses were mis-sold products which undermined their businesses, leading to cases of great personal hardship and bankruptcy highlighted by Bully Banks whose campaigning forced the issue into the open.

Box 3: Interest Rate Hedging Products

An FCA review launched in 2012 into the sale of Interest Rate Hedging Products (IRHPs) identified serious failings in the sale of IRHPs to some small and medium enterprises (SMEs). The failings highlighted included:

- Poor disclosure of exit costs;
- Failure to ascertain customers' understanding of risk;
- Non advised sales straying into advice;
- Sales of products driven by rewards and incentives.

A common complaint about the sale of IRHPs is that those selling them did not adequately explain the risks involved. One downside of IRHPs is that if interest rates fall substantially, as they did following the financial crisis in 2008, the customer does not benefit from these lower rates, but is locked into a rate above the prevailing market rate. If the customer wishes to break the contract, they are often faced with punitive breakage fees. Evidence suggests that in numerous cases these risks were not adequately explained to customers. This was because many banks employed specialist teams who earned high levels of commission to sell IRHPs, and were thus incentivised to accentuate the positives and downplay the negatives.

Following completion of the review, the FCA announced they had reached agreement with four banks – Barclays, HSBC, Lloyds and RBS – to provide appropriate redress where mis-selling was deemed to have occurred. However, the review and subsequent redress process has been criticised due to its perceived failure to adequately indentify and compensate many of those who lost money through IRHPs. Customers falling within this category include "sophisticated" customers – i.e. those adjudged to have sufficient expertise to understand what they were being sold – and many of those who suffered "consequential losses" after being sold IRHPs, for example lost interest or profits.

Although banks have missed the redress deadline agreed with the FCA, more than £1.5 billion has now been paid to SMEs in IRHP compensation. FCA figures suggest that taxpayer-owned RBS is by far the worst offender: of the 15,400 sales at redress offer stage at the end of September, 7,300—nearly half—belonged to RBS (and this is not necessarily indicative of their overall exposure).

4.6 The vital relationship of trust between banks and other businesses and customers has been broken by these scandals, and by the experiences of other businesses and customers who do not feel that banks are recognising or responding to their needs. As Martin Wheatley, CEO of the FCA, has said, we need "a culture that puts their [banks] customers first, rather than focusing on boosting profits and bonuses for sales staff".[40]

[40] Daily Telegraph,3 March, 2014 http://www.telegraph.co.uk/finance/personalfinance/consumertips/banking/10674180/Martin-Wheatley-We-cant-change-bank-bonus-culture-overnight.html

4.7 At the root of many of the problems in the banking sector has been the fact that instead of retail banks focusing on the needs and priorities of their business and individual customers, the investment banking culture of maximising short-term sales (at the expense of the long-term needs of customers) and rapid growth has come to dominate. The ring-fence between investment and retail banking, recommended by the Independent Commission on Banking, will be crucial to ensuring that the two cultures are kept separate.

4.8 Labour achieved the toughening up of the ring-fence recommended by the Independent Commission on Banking between investment and retail banking during the course of the Financial Services (Banking Reform) Act. Labour has also been clear that if we do not see a change in the culture of banks, and the implementation of the letter and spirit of the Independent Commission on Banking proposals, then the next Labour government will break them up by legislating to split investment from retail banks.

4.9 Many in the banking sector have been working to change culture. The biggest banks and building societies supported the independent Banking Standards Review by Sir Richard Lambert, which found "there is a strong case for a collective effort to raise standards of behaviour and competence in the banking sector, and that the best way to deliver this is by setting up a new and independent body to drive the process forward".[41] He recommended the establishment of a Banking Standards Review Council which would, among other things, require programmes of continuous improvement, standards of good practice, annual reports on progress, a single principles-based code of practice, and the identification and encouragement of good practice.

4.10 But the culture of banking will only change when incentives in the sector – particularly around pay – have changed. Pay needs to be proportionate to the contribution of bankers to the economy, and relate to the performance of the banks, both in the short and long-term.

4.11 Chapter 1 set out how long-termism in pay is key to ensuring the stability of the financial system. But the Governor of the Bank of England has also shown how it is also an issue of culture, arguing that reforming compensation in banks – alongside ending too-big-to-fail, creating fair and effective markets, and building a sense of vocation and responsibility – is essential to re-building social capital, and delivering a more trustworthy, inclusive capitalism. As he has said, a lesson from the financial crisis was that compensation schemes that delivered large bonuses for short-term returns encouraged individuals to take on too much long-term and tail risk. Compensation and long-term risks need to be aligned.[42]

4.12 His conclusions built on those of the Parliamentary Commission on Banking Standards. One of the key themes of the Commission was "making individual responsibility in banking a reality, especially at the most senior levels", with recommendations that[43]:

[41] Lambert review http://www.bankingstandardsreview.org.uk/assets/docs/may2014report.pdf
[42] Mark Carney, May 2014
http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech731.pdf
[43] Parliamentary commission on banking volume 1, http://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf

- Much more remuneration to be deferred and, in many cases, for much longer periods of up to 10 years;

- More of that deferred remuneration to be in forms which favour the long-term performance and soundness of the firm, such as bail-in bonds;

- The avoidance of reliance on narrow measures of bank profitability in calculating remuneration, with particular scepticism reserved for return on equity;

- Individual claims on outstanding deferred remuneration to be subject to cancellation in the light of individual or wider misconduct or a downturn in the performance of the bank or a business area;

- Powers to enable deferred remuneration to Senior Persons and licensed individuals, as well as any unvested pension rights and entitlements associated with loss of office, to be cancelled in any case in which a bank requires direct taxpayer support.

4.13 As set out in chapter 1, the PRA and FCA have not gone as far as the recommendations of the Parliamentary Commission, but have set out proposals to defer remuneration for up to 5 years for material risk takers and 7 years for senior managers.

4.14 The level of pay and bonuses to some highly paid bankers has also been disconnected from the performance of banks and their wider economic contribution. Despite the scandals of the past year, including the record forex fines in November, the early evidence suggests that bankers are in for another generous round of bonuses. Last year's bank bonus round saw the level of bonuses paid by a number of banks increase dramatically. While thousands of bank employees are struggling on modest salaries and facing a rise in the cost of living, those at the top are benefiting from high and rising bonuses, reinforced by the Government's tax cut for the top one per cent.

4.15 Compared to the previous year, bonuses at Lloyds increased by eight per cent to £395 million[44] and bonuses at HSBC went up six per cent to £2.3 billion.[45] Barclays paid bonuses to employees of up to £2.4 billion in 2013.[46] This meant that bonuses rose 10 per cent on the previous year, despite a 32 per cent fall in profits in 2013. It also resulted in 481 employees being paid in excess of £1 million.[47]

[44] Reuters, 13 February 2014, http://uk.reuters.com/article/2014/02/13/uk-lloyds-earnings-idUKBREA1C01D20140213
[45] Reuters, 24 February 2014, http://uk.reuters.com/article/2014/02/24/uk-hsbc-earnings-idUKBREA1M15C20140224
[46] Barclays Annual Report 2013, http://www.barclays.com/content/dam/barclayspublic/docs/InvestorRelations/AnnualReports/AR2013/2013-barclays-annual-report-final.pdf
[47] Barclays Annual Report 2013, http://www.barclays.com/content/dam/barclayspublic/docs/InvestorRelations/AnnualReports/AR2013/2013-barclays-annual-report-final.pdf

4.16 The past year has seen further evidence of shareholder unease regarding large pay outs, including from institutional shareholders. Over a third of shareholders, including institutional shareholders Standard Life Investment, failed to back Barclay's remuneration plan, with 24 per cent voting against it.[48] 41 per cent of Standard Chartered's shareholders opposed the bank's remuneration policy, compared with just 7 per cent the previous year.[49] Meanwhile, more than a fifth of HSBC's shareholders voted against the bank's proposed pay package.[50]

The Government's Failure to Change the Culture of Banking and Excessive Pay

4.17 The Government has been slow to act on scandals such as the mis-selling of interest rate swaps, and front-line staff in the sector working directly with customers in branches, report that the culture of banks is changing slowly, if at all. Although some of the overt incentives to sell products to customers – whether or not they are in the customer's interests – have been removed, there is still indirect pressure to do so.

4.18 Front-line staff in the banking sector are often low paid and work long hours, and are caught between the exploitative culture of the sector and the frustration and sometimes anger of bank customers. While much of public debate focuses on highly paid bankers who abuse the system for their personal gain, the vital role of front-line staff who work hard to provide services to communities and – like many others – are themselves struggling with the cost of living needs to be recognised and appreciated. They should not be tarred with the same brush and reform needs to succeed for those working in the banking sector as well as the wider economy.

4.19 Cultural change is complex and requires action in a range of areas as well as strong leadership from within the sector. But it also needs to be backed up with a robust regime to tackle criminal behaviour, ensure that those who are responsible for abuse pay the penalty, and protect the reputation of the City of London. Labour forced the Government to conduct a review into the culture of the sector following the revelations of Libor manipulation and has been highlighting the problems and lack of action on financial benchmarks and commodity prices since 2012.

4.20 The abuse of benchmarks such as Forex – where traders used confidential client information to manipulate the "fixing" rate for their own personal gain – can take several years to be revealed, meaning that tougher rules are needed to hold them responsible. Although the possibility of benchmark rigging was raised in 2012 – when Libor came to light – evidence suggests that Forex manipulation was still occurring as late as October 2013. We first raised the issue of Forex manipulation in 2012, yet the Government failed to put the rules in place to allow bonuses to be deferred and clawed back over a sufficiently long period, so that bankers are focused on the long-term success of their banks or have to pay a personal penalty for abuse.

[48] BBC News, 24 April 2014, http://www.bbc.co.uk/news/business-27137764
[49] Reuters, 8 May 2014, http://www.bloomberg.com/news/2014-05-08/standard-chartered-profit-declines-as-emerging-currencies-weaken.html
[50] Financial Times, 23 May 2014, http://www.ft.com/cms/s/0/a05f4f0a-e27a-11e3-89fd-00144feabdc0.html#axzz33fC5UnhT

In November 2014, the FCA imposed record fines totalling £1.1 billion on five banks for "failings in their business practices around G10 spot foreign exchange trading."[51] The Government had failed to act prior to this, despite Labour calling for proper regulation of the commodities market and benchmarking in 2012, and tabling amendments to the Financial Services (Banking Reform) Act 2013 to extend the regulation of benchmarking.

4.21 The policing of the City not only requires new rules, but also effective authorities to enforce them. The resources available to the Serious Fraud Office (SFO) are inadequate and conviction rates have declined in recent years while senior staff have received high payouts. Criminal fines imposed by courts in England and Wales are also weak by international standards, and the SFO's record on the confiscation and collection of assets is poor.

4.22 The Government has clearly failed to address the issue of high pay and bonuses for those at the top of the sector and investment bankers. They have refused to repeat the successful Bank Bonus Tax which Labour implemented in government, raising over £3 billion, or to increase the bank levy, which has consistently raised less than projected. They have also refused to implement legislation passed by Labour which gave the Treasury the power to require banks to disclose details of the number of employees earning more than £1 million, broken down by bands of pay.[52] The disclosure regime was due to come into force for annual reports in respect of 2010 issued in early 2011; however, the Government did not implement the change.

4.23 In fact, those on the highest pay in banking and financial services were among the main beneficiaries of the Government's top rate tax cut. When the additional rate of income tax was cut from 50 per cent to 45 per cent in April 2013, there was a strong incentive for those benefiting from the tax cut to defer bonuses until after the tax cut had taken place. This is what took place, and bonuses in financial and business services were 76.4 per cent higher in April 2013 than in April 2012.[53]

4.24 The failure of the Government to address excessive remuneration and large bonuses, and their weakness in European negotiations, has led to the unsatisfactory situation where the European Parliament has had to act with the cap on bankers' bonuses through EU Capital Requirements Directive IV. It is welcome that the Government has finally bowed to pressure from the Labour Party and public and refused to give permission for RBS to pay bonuses twice the level of salary. However, other banks have requested permission from shareholders to do this and are looking at mechanisms to get round the cap through fixed pay allowances. The Government have compounded their failures by wasting taxpayers' money on a legal challenge to the cap, which they have now abandoned. What we really need is a solution from the UK Government, which is rooted in a UK context.

4.25 Excessive and undeserved pay is not just an issue of fairness. It means that resources which the banks should be using to provide support to other businesses are instead being used for remuneration.

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[51] FCA, November 2014, http://www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings
[52] Financial Services Act 2010, http://www.legislation.gov.uk/ukpga/2010/28/contents
[53] ONS, Labour Market Statistics

4.26 The same applies to tax avoidance. The current Government has failed to address tax avoidance by individuals and companies. The UK's tax gap currently stands at £34 billion. When banks, or their subsidiaries, actively help customers to avoid or evade tax, they are diverting resources away from the UK Exchequer; funds which could otherwise be invested in public services or used to reduce the deficit and pay down the debt.

Labour's Plan for Reform

4.27 The current Government has shown itself to be incapable of either reining in excessive bonuses or clamping down on fraudulent practices within the banking industry. A Labour Government would change the culture of banking so that it serves other businesses, tackling excessive bonuses, and ensuring that bankers who break the rules are held accountable. The first Finance Bill of the next Labour Government will clamp down on tax avoidance and evasion. This will include closing the loopholes currently exploited by hedge funds to avoid paying Stamp Duty Reserve Tax through the use of intermediaries' relief.

4.28 Labour will implement longer-term pay incentives to change the culture in the banking sector, hold those who abuse their position to rip off customers to account, and improve stability by making bankers personally responsible for the risks they take. Therefore, the deferral period for bankers taking material risks should be at least 7 years, and for senior managers it should be 10 years, in line with the recommendations of the Parliamentary Commission on Banking Standards. Clawback should also be extended to at least 10 years after bonuses are awarded.

4.29 Labour would repeat the successful tax on bankers' bonuses which was implemented in 2009-10. The revenue would be used for a Compulsory Jobs Guarantee providing a job for every 18 to 24 year old who has been claiming Jobseeker's Allowance for more than a year. We would also increase the bank levy in order to generate an additional £800 million, which we would use to provide 25 hours of free childcare for working parents of three and four-year-olds.

4.30 Bonuses should be a reward for success, not a compensation for failure. A Labour Government would increase transparency around remuneration and bonuses by enacting the powers, legislated for by the last Labour Government, to require banks to publish the number of employees earning more than £1 million.

4.31 Bankers who exploit their customers or take excessive risks should personally face the consequences. We will introduce a legally enforced Code of Conduct for bankers so that those who act recklessly can be struck off. In common with codes of conduct which operate in the legal and medical professions, the Code of Conduct for the banking industry would place a strong emphasis on professional ethics, and stress individual responsibility for maintaining high ethical standards.

4.32 Labour will also tackle fraud and market manipulation through an Economic Crime Bill, and will examine ways to firm-up the UK's penalties regime for White Collar Crime, explore the potential to expand the SFO's recent practice of recruiting lawyers from the private sector for specific cases and consult on whether more of the proceeds of crime could be channelled back into law enforcement to help future victims recover their losses.

Next Steps

Not only is the banking and finance sector an important source of jobs and exports for the UK economy, but it is also vital for serving the needs of other businesses. In particular, support for small and medium-sized businesses to start-up and grow is essential for raising productivity and growing the economy in a way which raises living standards for working people.

The package of reforms set out in this paper – on stability, competition, access to finance and culture and pay – will ensure that the UK's banking sector is serving the needs of the wider economy.

Labour will now consult on the implementation of the plan set out in this paper and work with relevant authorities and regulators for its delivery.

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