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Subverting Safer Finance

How the UK holds back global financial regulation

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nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.

This report argues that the UK is subverting progress towards a safer financial system, and has become a major barrier to international efforts for reform. Compared even to the US, a jurisdiction with a reputation for market friendly regulation, and other major international jurisdictions, the UK is found to be part of the problem in key areas of financial reform, and not leading the search for solutions.

Contents

Executive Summary

This report argues that the UK is subverting progress towards a safer financial system, and has become a major barrier to international efforts for reform. Compared even to the US, a jurisdiction with a reputation for market friendly regulation, and other major international jurisdictions, the UK is found to be part of the problem in key areas of financial reform, and not leading the search for solutions.

In areas including potentially damaging commodity speculation, the Alternative Investment Market, naked short-selling and the operations of British tax havens, the UK is holding back urgently needed regulation. *Subverting Safer Finance* finds that:

- London is a major centre for commodity trading, yet instead of demonstrating leadership, the UK is lagging ever further behind the US. And while the EU is trying to support global regulation by raising standards towards those of US legislation, the UK's response is to block any attempt at reform.
- A London exchange called the Alternative Investment Market (AIM), has pursued a strategy of winning new business by driving down standards of transparency, governance and investor protection.
- The US banned naked short-selling (a form of trading that many argue increases market volatility and instability) in 2008. The European Parliament is seeking to impose an EU-wide ban on naked short-selling. But, the UK government is trying to derail this initiative.
- While the UK claims it cannot influence tax havens, many of which territories are in fact UK Crown Dependencies or Overseas Territories, a past history of intervention suggests otherwise. An HM Treasury review confirms that the UK has reserve powers enshrined in the constitutions of the Overseas Territories to affect and block legislation.[1] The UK also has the power to intervene to uphold 'good governance' in the Crown Dependencies. This means that in several cases the UK is actively choosing to not tackle tax havens.

In order for the UK to demonstrate that it wants a to deliver a safer financial system, we believe the minimum necessary actions include:

- Bring standards up to US levels by introducing position limits on speculators in commodity markets and creating a UK equivalent of the US Commodities Futures Trading Commission.
- Eliminate tax havens that are under UK control, and work with the US, the EU and other international authorities to co-ordinate regulation of global tax evasion and avoidance.
- Ban naked short-selling to bring the UK into line with the US, Japan, Hong Kong, India and Australia.

Introduction

In the UK, we are continually presented with the idea that foreign nations stand in the way of global financial stability. For example, we're told that we can't regulate the banks to the full extent we would like, because they will move to more 'business friendly' jurisdictions.

There is a preoccupation with maintaining 'competitiveness' and the UK's 'pre-eminence as a global financial centre', but very little discussion, beyond reminders of tax-revenues stemming from The City, of what this 'pre-eminence' has meant in practice. In particular, no one seems interested in asking to what extent other nations look upon the UK itself as a 'haven' that stands in the way of global financial stability.

This report demonstrates that, in many regards, the UK is still 'light-touch' and possibly a 'soft touch', even by arch-neoliberal US economic standards. Whilst the report is not intended as a comprehensive survey, it provides a flavour of how the UK has, in many instances, actually subverted attempts to implement higher standards of regulation internationally.

By exploring a few key regulatory areas, it demonstrates that the UK frequently benefits from financial firms 'shopping-around' to find slack regulation. By attracting business away from more prudent jurisdictions, the UK exerts a downward pressure on the quality of financial regulation. This finding starkly contrasts with the dangers of Britain 'acting unilaterally' that are frequently voiced by the banking lobby and the UK press, in response to even the slightest hint of real reform.

The UK has not rejected all international reform initiatives, adopting the new Basel III capital requirements and a bank levy. But, the report highlights key areas where the UK is dragging down global regulatory standards, and asks whether The City's taxes are really worth the broader costs and consequences of this behaviour.

Commodity markets: Junk and disorderly

Food, energy and minerals. From consumers to producers, from North to South, our prosperity depends on orderly markets in such vital raw materials. However, increased speculation and large price fluctuations have prompted concern that lax regulation and insufficient transparency are exacerbating already volatile markets.

London is a major centre for trading in commodities and yet far from demonstrating any leadership on this issue, the UK is resisting global reform efforts. The UK always lagged substantially behind the US, but with the recent passage of the Dodd-Frank Act, the gap has widened even further. The EU is trying to support global regulation by raising European standards towards those of US legislation. However, the UK is resisting key reforms.

Excessive Speculation

Commodity markets comprise producers and consumers, referred to as 'commercial traders', and purely financial or speculative traders. The latter do not produce or use the underlying asset being traded; they simply seek profits by buying low and selling high.

Speculative trading is meant to provide liquidity and help markets discover the correct price of an asset more efficiently. Liquid markets allow a buyer or seller to find their opposite quickly and easily, and this helps prices react smoothly to market conditions and keeps dealing costs low.

In theory, speculators extensively study the supply and demand dynamics of a market and so are better informed than commercial traders. Consequently, when the price of an asset deviates from its fair value, speculators will supposedly see this and buy (or sell) the asset until price equilibrium is restored.

However, the very high growth in the volume of speculative trading in recent years has led to mounting concern that excessive speculation is increasing volatility, and driving prices away from market fundamentals.

A cursory glance through economic history at the many bubbles and crashes that have occurred demonstrates that financial speculators often seriously mispriced products. One reason for this is the herd behaviour seen in markets, where speculators are being driven by emotion and what other speculators are doing, rather than by the realities of the underlying markets. Hence speculative trading may at times dominate the commodities derivatives markets, instead of supply and demand fundamentals. This can increase volatility, by causing the market to over- and undershoot in its response to news on fundamentals. The risk of excessive speculation is particularly acute given that speculators now constitute the majority of total participants in many markets.[2]

The importance of derivatives

Investors generally speculate on commodities by buying or selling derivatives. Derivatives are financial products whose prices are based on, or derived from, the expected future price of the underlying asset. For example, if an investor buys an oil future, they are agreeing to buy a given quantity of oil, at a given price, on a given day. If the price of oil subsequently increases, the investor profits from having bought the future. The ability to fix prices into the future is useful for producers and consumers in planning their business activity. Greater certainty over future cashflows makes investment and borrowing easier.

Efficient agricultural derivatives markets are essential if there are to be efficient physical markets in those commodities. This is because commodity derivatives markets and markets for physical commodities are linked. A report from the International Cocoa Organization (ICCO) describes this relationship:

> *"The [futures] markets for cocoa in London and New York play a vital role in the formation of prices for physical cocoa throughout the world. Indeed, in this respect, London and New York function as the benchmark for prices paid. Hence when prices in the two [futures] markets increase, prices paid to farmers increase. When prices in the [futures] markets fall, traders immediately react by paying lower prices to farmers. In addition, the [futures] markets provide a mechanism for market participants to hedge against price risk. For these reasons, it is of extreme importance that the [futures] markets are efficient and competitive markets."*[3]

Excessively volatile derivatives markets will lead to inefficient physical commodities markets by sending confusing price signals or by disrupting farmers' abilities to use the derivatives markets for hedging against risk. In this respect, the tail can wag the dog.

Have commodity markets become detached from reality?
Many governments and market participants increasingly express concern that commodities markets are behaving in a manner that cannot be explained purely by looking at economic fundamentals. For example, a 2009 report from the United Nations Conference on Trade and Development (UNCTAD) concluded that:

> *"financial investors have accelerated and amplified price movements driven by fundamental supply and demand factors, at least in some periods of time".*[4]

In 2009, the head of the International Food Policy Research Institute (IFPRI) said of agricultural derivatives speculation: "What we didn't foresee two years ago is how speculation exacerbated the real market issues. It was not a primary cause but a second-round amplifier, which added seriously to the problem."[5]

The investor George Soros said that food commodity speculation was, "just like secretly hoarding food during a hunger crisis in order to make profits from increasing prices". In 2011, 48 farm ministers from countries including Brazil, Russia and Japan expressed concern that "excessive price volatility and speculation on international agricultural markets might constitute a threat to food security".[6]

Similarly, the President of the Dominican Republic said that food speculation "24/7, with no authority around the world able to intervene and supervise" has resulted in "price behaviour patterns that are incomprehensible for many and certainly a big bother for all of us".[7]

Currently, economists are unable to either prove or disprove the theoretical effect of derivatives speculation on physical commodities markets, due to a lack of data. The US commodity markets regulator releases data on activity in futures markets, but no data is available on the opaque over-the-counter (OTC) markets, where financial institutions trade directly with each other, rather than via organised exchanges.

OTC markets for commodities derivatives have expanded dramatically in the past decade, and now dwarf the transparent exchange-based markets. OTC markets also encompass a much wider range of derivative products than can be traded on exchanges. No data is currently available, for example, on OTC commodities swaps or forwards, both of which are used extensively by speculators. Without this necessary data, the effects of uncontrolled speculation cannot be properly investigated. This is one of many reasons why a light should be shone on OTC transactions via centralised clearing or registration in trade repositories.

A UK government report into the 2007/2008 agricultural price spike is very revealing. It states:

> *"Some commentators have argued that a 'wall of speculative money' has had a distorting impact on agricultural commodity prices. Data imperfections, and the nature of the statistical tests that can be performed, make it impossible to definitively prove or disprove such arguments. Whilst theory allows for the possibility of speculation having an impact on prices in various ways, a review of the various potential mechanisms whereby speculation might have distorted markets suggests scepticism that speculators have played a significant causal role in the price spikes."*[8]

In other words, the UK government admits that financial theory may supports this link, and confirms that a lack of data prevents adequate investigation of the role of speculation in increased price volatility. Why, then, did the government not instruct the Financial Services Authority (FSA) to address the lack of information about such a critically important market?

What should the UK government do?

Given that excessive speculation has disrupted other markets, regulators must take this threat seriously. The financial crisis of 2008 demonstrated that unregulated markets are not safe, do not necessarily lead to the best outcomes for society or the economy, and that financial firms cannot be relied upon to self-regulate. The crash was a powerful advertisement for the failure of laissez-faire financial markets. Yet many financial traders, the banking lobby, and currently the UK government still maintain that uncontrolled commodities markets can work, and be relied upon faithfully to reflect the underlying fundamentals of supply and demand.

Banning speculation entirely would reduce the liquidity of commodities markets, but the alternative approach of introducing conservative position limits, which simply prevent market participants amassing excessively large positions, would have only a very minimal effect on liquidity.

Given the life-supporting importance of food and energy markets, taking no action would be neither prudent nor proportionate. As an excuse for inaction, to argue that the impact of speculation on the underlying market has not yet been statistically proven would be an illogical self-justification, because the lax regulatory approach to OTC trading actually prevents the statistics being gathered in the first place. A 'balance-of-probabilities' approach, or reversing the burden of proof to demand certainty, or at least high confidence, that unrestrained speculation has no harmful impact, would make for better regulation.

The US clearly thinks so, and the recent Dodd-Frank Act passed by Congress will increase the position limits imposed on speculators in US commodities markets. France and Germany have also taken a hard-line on excessive speculation in commodities markets,[9] and the European Commission is currently reviewing proposals that would help bring EU regulation up towards US standards.[10] However, the FSA and HM Treasury are resisting attempts to introduce even minimal position limits.[11]

In their 2009/2010 business plan, the FSA made a vague promise to reconsider whether commodities markets are sufficiently transparent.[12] Move forward one year and plans for reform have disappeared altogether. Commodities markets were not mentioned at all in the FSA's 2010/2011 business plan.[13]

The UK is isolating itself from other nations and financial centres by refusing to address this important issue.

Market abuse

The UK's failings in commodities regulation do not end with ignoring the potential harm to consumers and producers from excessive speculation and volatility. Unlike in the US, even minimal position limits, which guard solely against market abuses, such as 'squeezing' the market, are not in place in Britain. As a result, there is non-competitive behaviour in London.

During the summer of 2010 there was a shortage of cocoa in the physical market. Clearly noting these underlying conditions, an individual market participant started buying July-contract cocoa futures, and built up an enormous holding, effectively dominating the market for this contract. However, due to shortages in the physical market, not all of the July futures contracts in existence could be settled with the actual delivery of cocoa. Consequently, many of the market participants who had sold these contracts had to settle their obligations in cash. But as one participant had bought most of the contracts, they were able to 'squeeze' the settlement price to extract excessive profits.[14] The *Financial Times* (FT) reported that this manoeuvre "helped to push the cost of cocoa to a 33-year high of £2,732 a tonne".[15]

This is a form of market manipulation that could not occur in US commodities markets, where position limits prevent speculators from holding futures contracts worth more than 10,000 tonnes of cocoa in the run-up to delivery of the actual commodity ('expiry' of the contract), which thus protects against market abuse. This fiasco also illustrated the lack of transparency in London commodities markets. How could such behaviour go unnoticed until it was too late?

In the US, Commitment of Trader reports are published on a weekly basis. These disclose the number of contracts that have been bought and sold by the various types of participants, as well as the net positions held by each of the largest market players. Why is such information not available in the UK? The UK also discloses less information on European commodity inventories than is disclosed by the US on American inventories.

In allowing self-regulation by exchanges, the UK creates conditions for conflicts of interest. Exchanges profit from increased trading volumes, and therefore have an incentive to limit regulatory barriers. The US recognises this danger, and has an independent regulator: the Commodities Futures Trading Commission (CFTC). The UK desperately needs such a supervisor.

There also appears to be lax legal enforcement in the UK against the abuse of commodities markets. The FT revealed in 2008 that:

> *"The FSA has brought no civil or criminal cases in the energy markets since its establishment in 1997. By contrast, the CFTC uses a litigation-driven approach to policing markets. Since 2002, it has filed 39 enforcement actions in energy markets against 64 defendants, involving almost \$500m (£252m) in civil penalties."*[16]

In short, the US and other countries are actively intervening to help facilitate smooth-running commodities markets, whilst the UK is shirking this important duty, despite being a global centre for commodities derivatives trading. Far from it being a willing international co-operator, the UK's active resistance to reform is hampering efforts to modernise the international regulatory environment for markets in food, energy and other vital commodities.

Alternative Investment Market: Lowering standards

Stock exchanges increase their profits when more companies list their shares with them. As a result stock exchanges compete with one another to host new listings (known as Initial Public Offerings, or ‘IPOs’).

A London exchange called the Alternative Investment Market (AIM), has pursued a strategy of winning new business by driving down standards of transparency, governance and investor protection.

A 2007 report by McKinsey details how AIM attracts companies:

> *“A subsidiary of the London Stock Exchange, the Alternative Investment Market (AIM) has attracted more small-cap listings in recent years than any other exchange in the world. AIM’s success stems from the development of listing and reporting rules that make it as easy and economical as possible for small companies to tap the public equity markets. For instance, AIM has no minimal listing criteria; it does not require the filing of an LSE or FSA-vetted prospectus... companies need file only half-yearly accounts”.*[17]

Moreover, companies are allowed to circumvent even AIM’s minimal regulations, if they provide an explanation for their non-compliance. Compliance, even with lax rules, is therefore essentially voluntary.

The McKinsey report confirms that AIM’s lower standards are drawing business away from other, more regulated exchanges:

> *“The IPO market offers other examples of jurisdictional arbitrage working against the United States, with very small-cap companies in the US increasingly favouring London’s Alternative Investment Market (AIM) over NASDAQ... since the beginning of 2005, AIM has added more than twice as many companies (484) as its US counterpart (224)”*[18]

Free-market enthusiasts may cite this as proof that too much regulation imposes excessive costs on companies and investors, and that AIM’s strategy is a success. Not so, according to the McKinsey report, commissioned by the Mayor of New York City, Michael Bloomberg, and US Senator, Charles Schumer. McKinsey actually advises against lowering US regulatory standards in order to win back business from London. They note that small-cap companies are extremely risky investments, and thus decent investor protection measures should be in place:

> *“Small-cap markets are clearly riskier than their more established counterparts, mainly because smaller companies are less diversified and generally have fewer means of surviving adversity. Yet it is precisely when adverse conditions arise that investor protection measures are most important. In their efforts to make listing easier and cheaper for fledgling companies, small cap exchanges often relax some of the constraints on publically listed companies that provide the most protection for investors... This concern over the disproportionate impact that a bear market might have on small-cap markets and investors, along with the limited economic benefits associated with such markets, explains in part why this report does not recommend that US exchanges lower their listing requirements to attract more small issuers.”*[19]

Whilst some might consider "small-cap" companies to be too small to merit proper regulation, the average value of an AIM listed company is actually in the region of $70m.[20] Regulation is to assist investors who may lack the expertise and information to assess whether or not these firms are sound investments. So the lack of adequate governance from AIM becomes a dangerous omission, and all the more important given that there are tax incentives for investors to hold AIM shares.[21]

Small mining and natural resource companies make up around one third of the AIM. These are investments that are particularly speculative and dependent on transparency and accurate data. Yet even though smaller companies generally outperform larger ones, the opposite has been the case with AIM, as pointed out recently by the FT:

> *"the rule of small-cap outperformance continues not to apply to stocks that trade on AIM. Light regulation, an AIM selling point, has its appeals. But London's achievement in becoming the favoured venue for small resources companies raising capital looks all the more impressive for having to persuade investors to overlook a long record of underperformance."*[22]

It is questionable, in any event, whether it is really in the interests of UK investors for AIM to be so lightly regulated. Compared to the US approach, the UK once again is the regulatory laggard, encouraging a 'race-to-the-bottom'.

Naked Short-Selling

A short-seller borrows shares and sells them, anticipating that their price will fall, allowing them to re-purchase the shares later at a lower price, making a profit, and then return them to the lender.

If the short-seller correctly anticipates a fall in a company's share price, they will make money, as they have sold at a high price and repurchased at a low price. Obviously, short-sellers lose money if the share price instead rises.

By allowing traders who do not already own a share to take a view on its price, additional liquidity and pricing information is brought into the market. In theory this is meant to improve the efficiency of the market and the accuracy of prices. Market makers have always played this role, and the ability to sell now and buy back later allows prices to react quickly. The need to borrow the shares that are sold acts as a natural limit on the volume of such trading. The practice can also be applied to other traded financial instruments as well as company shares.

A *naked* short-seller sells shares without first arranging to borrow them. The seller may then successfully find shares to borrow and deliver, or the trade may simply 'fail to deliver'. The trade remains open until shares are finally delivered. This means that naked short selling is a mechanism through which unscrupulous traders can quickly sell an enormous number of stocks without first having to source the shares.

Supporters argue that naked short-selling further improves liquidity, with the same benefits as traditional short-selling. However, many others argue that it is predatory and often amounts to market manipulation, as, if the shares do not first have to be sourced, then theoretically an unlimited number of shares can be sold. The practice therefore opens the door for share prices to be driven down artificially, which may additionally spark widespread panic-selling.

It is particularly damaging when vulnerable companies are targeted aggressively by naked short-sellers, who then destroy any remaining market confidence, and drive companies to the brink. Smaller companies are particularly at risk, as their stocks are less liquid. After researching naked short–selling, Robert Shapiro, a former US Undersecretary of Commerce, concluded that it had ruined 1,000 firms and wiped $100 billion off share prices.[23]

Naked short-selling is not the only way that speculators can bet on the demise of a company, or the default of a creditor. They can also enter into credit default swaps (CDS) which effectively allow any party to buy insurance against a creditor failing to repay their outstanding debt. This practice is also controversial, and action has been taken to restrict it in some jurisdictions, notably Germany. Although no international consensus has developed around the merits or otherwise of CDS trading, such a consensus has developed around the issue of naked short-selling – with the notable exception of the UK.

The US banned naked short-selling in 2008. The Chairman of the Securities and Exchange Commission (SEC), the US securities regulator, called naked short-selling a "particularly pernicious form of fraud"[24] and declared that the SEC would have, "zero tolerance for abusive naked short selling".[25] The European Parliament's Economics and Monetary Affairs Committee recently voted to effectively ban naked short selling, and will now work with the European Council to draft legislation that will then be put to the European Parliament.[26] However, the UK government is trying to derail this initiative:

> *"The UK does not support permanent restrictions on the uncovered short sales of either equities or sovereign debt … we believe it will do much to impair liquidity."*[27]

Naked short-selling has already been banned in the US,[28] Japan,[29] India,[30] Australia[31] and Hong Kong.[32]

Once again, the UK demonstrates a preparedness to jeopardise the integrity of the wider financial markets in order to attract hedge funds according to a limited, misguided and ultimately self-destructive view of national interest. Such an approach puts the wealth of a handful of speculators ahead of the broader interests of the UK economy, British citizens and the global harmonisation of regulatory standards.

British Tax Havens

We are used to thinking of tax havens as places very different to, and separate from the UK. However, in his recent book, Nicholas Shaxson argues that tax havens are in fact "controlled by the world's major powers, notably Britain and the United States".[33]

Britain, for example, is affiliated to a large array of tax havens in the form of Crown Dependencies. These include Guernsey and Jersey, and Overseas Territories such as the Cayman Islands.

A 2009 independent review, commissioned by HM Treasury, into the three Crown Dependencies and six of the Overseas Territories (hereafter referred to as "HMT review") states that:

> *"Within the offshore market… the nine jurisdictions account for over 60 per cent of total financial flows through the banking system."*[34]

Moreover, a recent OECD report claims that one of Britain's jurisdictions, Guernsey, has not yet fully complied with the very minimal international standards on tax transparency.[35] Nicholas Shaxson argues that the City of London has deliberately fostered this network:

> *"The British havens scattered all around the world's time zones attract and catch mobile international capital flowing to and from nearby jurisdictions, just as a spider's web catches passing insects. Much of the money attracted to these places, and the business of handling that money, is then funnelled through to London."*[36]

Evidence cited in the HMT review backs-up this analysis:

> *"The UK has consistently been the net recipient of funds flowing through the banking system from the nine jurisdictions… The Crown Dependencies… provided net financing to UK banks of $332.5 billion in the second quarter of calendar year 2009."*[37]

The UK often claims that these jurisdictions are fully autonomous, and that it is therefore unable to exert influence. However, the UK's past history of intervention suggests otherwise. For example, in August 2009 the UK government suspended their counterparts on the Turks and Caicos Islands for up to two years and imposed UK-rule, in response to widespread corruption inside the local government.[38] The HMT review confirms that the UK's ability to exert control is assured by reserve powers enshrined in the constitutions of the Overseas Territories. These include the power to block legislation and also, apart from Bermuda, the power to introduce new legislation to further peace, order and good government.[39] Similarly, whilst the full constitutional relationship between the UK and the Crown Dependencies is difficult to discern, the UK does have the right to intervene to uphold "good government", which is left undefined.[40]

The close UK link is underlined by a National Audit Office report which states that that: "The great majority of Territory citizens have been entitled to full British citizenship."[41]

The UK must no longer pretend it has nothing to do with this offshore network, and instead should shoulder its share of responsibility to guarantee the 'good governance' of these jurisdictions. As a starting point, the government should ensure that Guernsey meets the minimal international agreed standards.

Conclusions

Instability stemming from poorly regulated financial markets has caused untold economic damage in recent years, the consequences of which we will live with for many years to come.

There is a broadly agreed international consensus that better regulation, and new checks and balances are urgently needed.

However, far from championing better regulation and showing international leadership, in key areas the UK appears to be subverting efforts to create a safer financial system.

Even in comparison to the US, seen by many as the home of aggressive market economics, the UK is lagging behind.

In areas including the commodity markets, the Alternative Investment Market and naked short-selling, the UK is holding back urgently needed financial regulation. The UK also appears to be taking a soft approach to the operation of British tax havens, accounting fraud, global tax evasion and avoidance.

Since the 1980s, the financial services industry has reaped the benefits of a global 'race-the-the-bottom' in regulatory standards. Rather than co-operating, nations have pitted themselves against each other.

Britain can no longer excuse its approach in key areas with the argument that, "if we don't do it, someone else will", when other global financial centres, such as the US, are unilaterally opting to impose checks and balances on their financial sectors, even knowing that the UK is not acting in tandem.

When the UK government announced the results of 'Project Merlin', the recent lacklustre attempt to reign-in bankers' pay, dubbed 'meaningless twaddle' by the Daily Telegraph, it proclaimed that:

> *"The Government is committed to maintaining a strong, resilient, stable and globally competitive UK financial services sector, in which UK banks can compete with the best banks in the world on a level playing field."*[42]

Honestly meant, this is a laudable aim. But the playing field will not level itself and, if anything, in key areas the current UK approach is to tilt the ground still further, making the playing surface more uneven. Now is the time for the UK to step up, and stop subverting many key global reform initiatives.

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What can be done to take back our banks?

Even on its own terms the banking system is broken. To design one that is fit for purpose and able to underpin the imminent great transition to a new, low-carbon, high well-being, and stable economy, we need to revisit the social and economic contract that banks have with society.

Banking should be more like a public service, a utility that helps the productive economy function. That means a root and branch rethink. But to get us going, there are a range of things that can be done now.

Out with the old:

- Separate retail banking and speculation. Banks should separate out their risky activities and insulate their retail services from the volatility of international capital markets.
- Break up banks that are 'too big to fail'. Reduce banks to a size at which their failure would not threaten the wider economy.

In with the new:

- Create a national Post Bank based on the existing Post Office network to address financial exclusion and provide real, fairly priced competition in local communities.
- Finance the Green Investment Bank to channel finance towards developing the low carbon infrastructure we need, enabling existing industry to go green and to build the skills to make Britain a world leader in the field.
- Unshackle and promote alternative financial institutions such as credit unions and community development finance institutions, and back them with an adequately resourced Big Society Bank.

Effective incentives for better behaviour:

- Introduce new controls on bonuses to stop the activities of banks being warped by bankers chasing short-term speculative gains at the expense of long-term value creation.
- Introduce a financial transactions (or 'Robin Hood') tax. The IMF has proposed both a new levy on banks as well as a tax on profits and remuneration. But an automatic transactions tax has broad benefits too and should be brought in.
- Introduce a 'Statement of Purpose' requirement for banks and banking activities to allow regulators and customers to assess how much the activity contributes (or doesn't contribute) to a productive economy that serves society and protects the environment.

Ensuring fairness, transparency, and stability:

- Launch a competition enquiry into the banks that looks also at the role played by ratings agencies and accountancy firms. A competition inquiry is needed into the tight cartel of banks that raise funds for the government and companies in the international capital markets.
- Introduce a Universal Banking Obligation and ensure a taxpayer 'quid pro quo' for future bank support. There must be a Universal Banking Obligation which covers both location and a banking code covering the principles of fair charges, and ensures that everyone has access to essential financial services.
- Introduce a UK Community Reinvestment Act which insists that banks lend money where they are prepared to take deposits.
- Introduce country-by-country reporting this would makes banks disclose a profit and loss account and a limited balance sheet for every location (without exception) in which they trade. This would establish a link between what banks do and the people who ultimately bear the risk.

The Great Transition

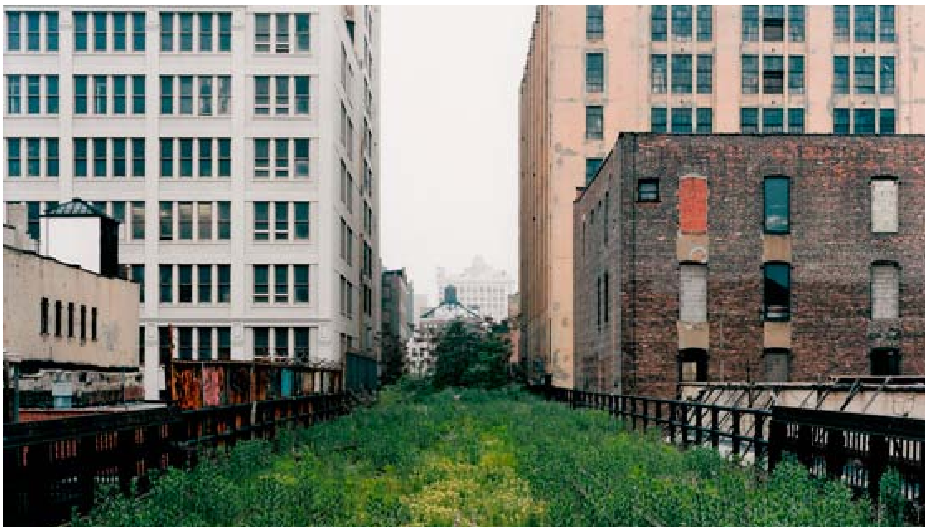

Photo: Joel Sternfeld

The Great Transition is a growing movement finding new ways for *everyone* to survive and thrive through financial crises, recession, climate change and the end of the oil age.

Securing the Great Transition is at the heart of all of **nef**'s work. But meeting the challenges we have identified needs new approaches. The Great Transition is a growing movement of individuals and organisations who recognise that creating a different world is necessary, desirable and possible.

At its heart is an emerging new economy built on well-being, social justice and the inescapable need to learn to live within our available biosphere. This calls for experiment, innovation and bold action by government, business and civil society. By working together to make change happen we believe we can make the Great Transition.

For more information please call 020 7820 6300

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With thanks to: Romit Jain and Tim Jenkins.

THE GREAT TRANSITION
Necessary Desirable Possible

This report is part of the Great Transition. Finding new ways for *everyone* to survive and thrive through financial crises, recession, climate change and the end of the oil age.

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