

FINANCIAL CRIME AFTER THE CRISIS IN THE UK

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Tackling Illegal Economies

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Abstract

Financial crime is a large area of political and social interest and includes a variety of illicit conducts which need to be isolated and addressed as discrete offences. Financial operations, however, may cause harm even when they do not possess a criminal nature, as events around the 2008 bank crisis have shown. This report is concerned with both typologies, namely with both illicit and licit harmful behavior by financial actors. The first section identifies specific forms of financial crime suggesting differences and similarities between tax evasion and money laundering. The analysis of these two types of offences leads to some points of clarification relating to the differences and similarities between white collar and organized crime. After highlighting the links between these forms of structured criminality, the report then provides, in the second section, an outline of the banking and financial system in the UK in an attempt to assess to what extent such system is conducive to illicit conduct. In the third section an account of the 2008 crisis in the country is offered. This is followed by the presentation of a number of case studies referring to recent episodes. Finally, the measures adopted in response to the financial crisis are examined along with their potential effectiveness.

Hot money

Tax evasion and money laundering share several techniques and can be mutually supporting, although operationally they are quite distinct pro-

cesses. Tax evasion consists in hiding or disguising the nature of legally earned income, therefore in turning legal money into illegal money. Laundering does the opposite, namely it turns illegal earnings into legal income. Tax evaders under-report their legal earnings, while money launderers over-report them. Both groups, however, deal with what we might describe as hot money, and are willing to use the services offered by very similar actors: bankers, financiers, smugglers, or front individuals and companies.

The stricter regulations aiming to unearth hot money are usually embedded in the assumption that the bulk of this money is drug-related, namely part of the proceeds of criminal organizations. In reality, amongst the various operations contributing to the international volume of hot money, drug trafficking is not prominent. The most relevant portions of hot money derive from tax evasion, flight capital and the proceeds of irregular or hidden economies, which are distinguished from criminal economies proper. Flight capital includes money made available by developed to developing countries in the form of financial aid, which is not spent or invested locally, but returns to the developed countries as illegally exported capital. This money is often deposited in the very bank that gave the credits in the first place.

It should be noted that regulations in this area, while attempting to hit on conventional criminal groups, appear to be inspired by the necessity to leave other actors untouched. In brief, regulations address organised crime, not white collar crime while excessive strictness would risk to hamper both. This is perhaps one of the reasons of the reluctance to reform or abolish the offshore system characterising the British financial world.

The term offshore is a relative one and, of course, implies the existence of an 'onshore'. A firm's offshore is taken to mean all activities not undertaken by the firm in its home country, but by its branches based abroad. As banks engage in competitive deregulation, and increasing invisibility characterises transactions performed by their foreign branches to the point that the distinction between onshore and offshore becomes blurred (Palan, 2009). In the grey area thus created, customers are offered a number of services within what is termed 'global custody'. A multitude of operations are initiated under global custody including security transfer, mergers and acquisitions, risk reduction and tax minimisation. The ability to use the un-

even global topography of taxation to gain advantage is now an imperative.

Tax havens offer 'escape routes from rules and laws elsewhere' (Shaxson, 2011: 6). Once the escape has been effected, the money is no longer elsewhere, but nowhere. The offshore system establishes a special set of rules for the elite, allowing corporations to pay tax rates far below ordinary citizens. Developed countries, by offering tax incentives and secrecy, may themselves turn into tax havens. The offshore system, in brief, 'binds together Libreville, Paris and Jersey; Luanda, Geneva and Moscow; Moscow, Cyprus and London; Wall Street, Mexico City and the Cayman Islands; Washington, the Bahamas and Riyadh' (ibid: 9-10). It is estimated that over half of all bank assets, and a third of foreign direct investment by multinational companies, are routed offshore (Palan, Murphy and Chavagneux, 2010). But let us move specifically to the country under examination.

The City of London is constituted by three layers. The first is identified with the small islands of Jersey, Guernsey and the Isle of Man. Here, estimates suggest that \$1 trillion of potentially tax-evading assets are hosted (Sullivan, 2007). The second layer involves Britain's overseas territories, the last remaining shards of the empire, which are inhabited by barely a quarter of a million people and enjoy top secrecy jurisdictions: the Cayman Islands, Bermuda, the British Virgin Islands, Turks and Caicos and Gibraltar. The third layer is constituted by an array of havens, such as Hong Kong and the Bahamas, which are not directly controlled by the UK, but maintain excellent business relationships with the City of London.

Informant 1: 'People have traditionally seen tax havens as marginal players used by mafiosi, drug smugglers, spies, petty criminals, and celebrity tax-dodgers. Plenty of these can be found offshore, it is true. But I need to stress again: The big users of secrecy jurisdictions are the banks and other financial institutions'.

In brief, the offshore network is not formed by independent countries governed by laws they have democratically chosen, but is a chain of jurisdictions monitored and influenced by major financial and industrial powers. Moreover, being attractive to prosperous elites in developing countries, this network receives financial assets which far exceed the reverse flow,

namely the foreign aid provided by developed countries. For every dollar that the West generously hands to developing countries over the counter, \$10 is taken back from them under the counter (Kar and Smith, 2008).

Tax havens networks, which enable global financial crime, have barely been reformed, despite a pledge to this effect by the G20 leaders in 2009. According to the campaign group Tax Justice Network, secrecy jurisdictions have become a central figure of global financial markets, creating the environment for fraud, avoidance of financial regulations, market manipulation, and money laundering. Campaigners focus on the 'financial secrecy index', which is used to rank the most problematic havens. The index is compiled from data on flows of finance through individual offshore centres and on the degree of cooperation offered by tax authorities in individuals countries. Switzerland is ranked first, after fighting hard against the EU urging the country to disclose information about wealthy customers. The Cayman Islands, a British overseas territory, is placed second, as according to Tax Justice Network 'it facilitates a huge number of opaque offshore companies and trusts which can be used to hide all sorts of illegitimate activities (Lawrence, 2011).

Case study 1

Informant 2 focused his attention on the channel islands, particularly Jersey, Guernsey, Sark and the Isle of Man, describing them as 'the worst tax dodgers'. In Jersey, foreign authorities are refused help in investigations on tax evasion and financial fraud. In the Isle of Man there are thousands of completely unsupervised companies whose owners are hidden. In Guernsey and Sark it is common for local residents to act as bogus 'nominee' directors for tax-dodging companies.

Informants 2: 'The Channel Islands make so much money that islanders enjoy a standard of living twice higher than that on mainland Britain. A vast service industry has sprung up, involving lawyers, solicitors, accountants and banks'.

Money to the Channel Islands also arrives in the form of payments to supposed suppliers servicing entrepreneurs based on mainland UK or in other countries.

Case study 2

Evidence of how the borders between legitimate and illegitimate practices are uncertain was provided by controversial news relating to the companies owned by former UK Prime Minister Tony Blair. Income channelled through a complex network of firms and partnerships controlled by Blair rose more than 40% in 2011 to more than £12m. Of this, almost £10m was paid for 'management services'. The money was transferred via a network of firms and financial vehicles. Accountancy experts questioned the arcane nature of the network's finances, which makes it difficult to trace where its money is coming from or where it is being spent. Windrush Ventures is the name of the pool of companies linked to the 'Office of Tony Blair', but exactly what sort of 'management services' are provided, and how the companies derive their income, are impossible to determine. Blair has provided advice and consultancy to charitable foundations for poverty relief projects in Sierra Leone and Rwanda, creating his own Africa Governance Initiative. He has also advised heads of states and global corporations, which led to criticism for the way his private and philanthropic activities tend to merge. He has lucrative consultancy contracts with luxury goods firms and insurance companies in Switzerland, has undertaken work for the royal family of Kuwait, an investment firm in Abu Dhabi and an oil company in South Korea. Blair is taking advantage of laws allowing him to limit what his companies and partnerships are required to disclose with the result that his accounts are far from transparent (Doward, 2012).

International aid is supposed to benefit small businesses and vulnerable peoples,

like for example the aid provided through the World Food Programme, whose finances consist of donations and is aimed at feeding the starving and committed to buying food from very poor farmers. However, during the 2011-12 period, more than £500m ended up in the hands of a London-listed commodities trader, Glencore International. This conglomerate, which buys up supplies from farmers and sells them on at a profit, was in that period the biggest single supplier of wheat to the WFP. 'In the latest half-year financial results, Glencore, which previously attracted controversy for environmental breaches and accusations of dealing with rogue states, reported that revenue from agricultural products doubled to \$8.8m'

(Neate, 2012). Betting on rising wheat price, lobbying for bans on exportations from some countries, taking advantage from droughts and investing in agricultural 'products futures' allow giant food wholesalers to capitalise on 'inert' donation finances and turn them into profit. As a technique of rationalization, wholesalers might well mobilise the argument that they are less corrupt and more ethical than arms producers, because they at least provide food, not weapons.

As mentioned above, concrete 'islands of illegality' are in function which, in turn, may hamper the decline of profits. Two final examples appear to confirm how such islands are also available to financial institutions. The 'London interbank offered rate' (*Libor*) was involved in criminal activity affecting more a dozen institutions on three continents. Investors were outraged when the scale of the offence was revealed, with Barclays Bank being asked to pay £290m in penalties for moving the exchange benchmarks and thus gaining illicit profits (Masters, 2012). HSBC, Britain's biggest bank, agreed to pay a record £1.2bn to settle allegations that it allowed terrorist organisations and drugs traffickers to move billions of dollars around the financial system (Rushe and Treanor, 2012).

The 2008 crisis

The pursuit of rapid profits by banks led to the largest destruction of value in world history during the crash of 2008. After old investment bank Lehman Brothers filed for bankruptcy, several other private financial firms on Wall Street and around the US followed suit. They had created the conditions that led to the collapse. "The risk of losses from the loans and mortgages these firms routinely bought and sold, particularly the sub-prime mortgages sold to low-income borrowers with poor credit, was significantly greater than regulators had realised' (Madrack and Partnoy, 2011: 23). Bankers, meanwhile, had made huge fortunes by selling the same mortgages in repackaged securities to investors throughout the world. The federal government was more zealous in rescuing bankers than prosecuting them (US Senate, 2011). Government rescue measures consisted in injecting liquidity into the financial sector, while leaving the system largely unchanged (Blackburn, 2011). In the US the Emergency Economic Stabilization Act, commonly referred to as a bailout of the country's financial

system, was designed as a response to the sub-prime mortgage crisis, authorizing the Treasury to spend \$700 billion to purchase distressed assets, especially mortgage-backed securities, and provide fresh capital to banks. After a series of amendments, President George W. Bush signed the Bill into law, launching the Troubled Asset Relief Program (TARP). The beneficiaries of the law argued that state intervention into the market was vital to prevent further erosion of confidence in the US credit system and that failure to act could lead to an economic depression. The cost of the bailout was estimated at \$2,295 per American (Associated Press, 2008). Treasury Secretary Henry Paulson used a sequence of Keynesian expressions to summarize the rationale of the bailout: the economy had to be 'stabilized', 'decisive action' had to be taken to address the root causes of the turmoil, the 'relief' programme should 'restore market confidence' (US Department of the Treasury, 2008). The plan created a conflict of interest, as Paulson was a former executive of Goldman Sachs, while a number of members sitting on the committee administering the bailout were also managers of the very institutions which had caused the crisis. Some commentators described the state action as financial socialism, something deeply un-American, while others commented: too much money for too few people. Yet others wondered whether decisions were being made by the US Congress or by the board of directors of Goldman Sachs. Investor George Soros (2008) opposed the Paulson plan because the purchase by the state of the Mortgage-related securities posed a classic problem of asymmetric information: the sellers knew more about them than the buyers, so that the Treasury would end up with 'the dregs'. Many criticised the plan for its unfairness, as it subsidised investors at taxpayers' expense: investors who took risks to earn profits must also bear the losses, it was remarked. Keynesian state rewards, in this case, were granted to bankers, though their contribution to society, and even to their firms, had been *negative*. 'The wealth given to the elite and to the bankers seemed to arise out of their ability and willingness to take advantage of others' (Stiglitz, 2012: xv).

Since the financial crisis began, Goldman Sachs provoked the most opprobrium. Described as a vampire squid wrapped around the face of humanity, the company was blamed for the housing bubble and accused of having survived only for its influence in high places. Since then the

firm suffered one public relations disaster after the other, 'culminating in a \$550 million out-of-court settlement to avoid persecution for fraud by the Securities and Exchange Commission' (Macdonald, 2011: 25). The lawsuit brought in 2010 accused Goldman of selling securities that they knew would fail and then betting against them. The case attracted enormous public attention both because of the already dubious reputation of the firm and because one of its employees, in an e-mail exchange, alternated boastful comments on the operation underway and tender intimate words with his interlocutor (Cohan, 2011).

On 8 October 2008 the British government announced a bank rescue package totalling some £500 billion as a response to the financial crisis. The plan aimed to 'restore market confidence' and help 'stabilise' the banking system, and provided a range of short-term loans and guarantees as well as up to £50 billion of state investment in banks themselves. Loans were made available through the Bank of England's Special Liquidity Scheme and a newly formed Bank Recapitalisation Fund. While Prime Minister Gordon Brown claimed that the UK were leading the way for other countries in the rescue operations, shadow Chancellor George Osborne stated that the manoeuvre was the final chapter of the age of irresponsibility (Barker, 2008). While the US rescue programme did not address the fundamental problem of solvency, the UK package tackled both solvency and funding, through the Bank of England's Special Liquidity Scheme. The government bought a combination of ordinary shares and preference shares in affected banks. In their turn, banks accepting the package were asked to impose restrictions on executive pay. The UK plan, in sum, was characterised by partial nationalisation (Graeme, 2008), rescuing first Northern Rock, then Lloyds TSB group and the Royal Bank of Scotland. Initially, HSBC and Barclays rejected the rescue offer, and the former claimed that, after injecting £750m into its coffers, it was now one of the most strongly capitalised banks in the world. Eventually, both were forced to accept help from the US relief programme.

In 2011, Northern Rock, whose collapse was the harbinger of the credit crunch in the UK and of the subsequent recession, was sold to Virgin Money for £747 million, while the cost of its nationalisation had been £1.4 billion. The sale was made because the European Commission had placed

a limit on how long the bank could stay in state ownership. 'To sum up: the Virgin deal guarantees big losses for the taxpayer, uses exotic financial techniques analogous to those which caused the Rock to collapse in the first place, and leaves us with a bank which is measurably less safe' (Lanchester, 2011: 18).

Both Wall Street and the City of London were mainly unaffected by state control efforts: 'outrageous bonuses, perverse incentives, slender capitalisation, obscure accounting rules, off-balance-sheet items and special-purpose entities remained untouched' (Blackburn, 2011: 36). It is true that one distinguished protagonist was 'harshly' punished: Fred Goodwin, was stripped of his knighthood, awarded to him years earlier for the 'great services' provided to the bank industry (Wintour, 2012). If part of the funds had been given to low-income debtors, the operation might have contributed to creating demand and thwarting stagnation, as would have a massive programme of public investment in infrastructure and in form of aid to small and medium businesses.

In 2012, UK Prime Minister David Cameron was under fire for failing to block a bonus of nearly £1m for Royal Bank of Scotland's chief executive, Stephen Hester. He blamed the previous government for negotiating a contract that prevented state interference in what was, de facto, a state-controlled bank. Nothing in the employment contract of Stephen Hester or any director of Royal Bank of Scotland bound the company to pay mandatory bonuses. Bob Diamond, chief executive of Barclays, commented: "If we don't celebrate reward for success we don't have an economy". Diamond declined to comment on the scale of his own bonus, which could be in the region of £10m. Chancellor George Osborne added: 'The alternatives (to the Hester payout) would have been worse for the taxpayer. Either there would have been a much larger bonus, of the kind he would have got a few years ago. Or the British government would have had to take over complete ownership of RBS and over-ruled the board, and I think that would have cost the taxpayer more as well. The bonus affair was termed a disgraceful failure of leadership by a member of the opposition: Cameron, through the British government, owns 83% of the RBS. 'He must now explain to the British people why he has allowed this to happen' (Watt, Elliott and Treanor, 2012). Moreover, the RBS spent more than \$4m of

British taxpayers' money on lobbyists in Washington since it was bailed out by the government. In-house and commercial lobbyists were paid to influence congressmen reforming US finance law since the bank's collapse in October 2008. The bank activated lobbyists over proposed consumer protection legislation making it harder for young people to be given credit cards, have their credit limit extended and impose limits on interest rates. In 2009 and 2010, the RBS subsidiaries also lobbied on the Dodd-Frank Wall Street Act, the largest US banking reform act. This covers the amount of capital banks must hold as well as demanding that banks publish the ratio of their highest pay to average wages. British public money was spent to lobby against this Act (Syal and Hughes, 2012).

Preventing future crises?

Proposals and initiatives to reform the banking system in the wake of the crisis have multiplied. In December 2009, the Basel Committee on Banking Supervision remarked that banks entered the crisis with too little capital and poor efficiency. In response, the suggestion was made to harmonise the capital reserves, monitor standards of bank liquidity and establish a 'leverage ratio'¹. Suggestions were also made in relation to assessment and prediction of risk in financial operations in general.

The document released by the Basel Committee made some commentators observe that it is not enough to 'tighten a screw here and put in a new nail there': the entire ship of banking regulation needs a thorough overhaul (Hellwig, 2010). Moreover, the regulatory community was accused of sticking to a tradition of discussing among bureaucratic cognoscenti, without even trying to explain to the public at large the effects that the new measures are expected to produce.

Critics have argued that responses to the major cause of the crisis are not being devised. Such causes include:

¹ In finance, leverage is a general term for any technique to multiply gains. Most often this involves buying more of an asset by using borrowed funds. The belief is that the income from the asset will exceed the cost of borrowing. As the 2008 crisis demonstrates, this involves the risk that borrowing will be larger than the income from the asset, causing loss or even collapse.

- deregulation and increased interconnection of the financial system at the global level;
- the growth of a shadow banking system offering short-term loans while relying on the profits of long-term investments;
- the excessive sale of assets aimed at recovering loss, which turned instead into further losses.

As for the proposed measures oriented toward prediction of risk, these were deemed ineffective, because risk cannot be reliably measured.

In July 2011, the European Parliament and the Council of Europe issued an 'Alternative Investment Fund Managers Directive'. The Directive regulates EU managers who deal with hedge funds and private equity funds, it establishes general operating conditions and limits to leverage, while calling for transparency and stricter supervision. It also fixes a ceiling for remunerations and bonuses for bankers and brokers, and requires the appointment of independent risk managers and evaluators. Although EU countries were expected to turn the provisions of the Directive into national legislation, as of April 2014, 16 member states had failed to do so. Asset managers operating in the UK regard the Directive as an obstacle to competition and, in their opinion, will reduce the number of overseas agents operating in the EU.

Zombie funds

The City regulator called in lawyers to scrutinize the announcement of an investigation into 30 million pension and investment policies. The news sent shares in leading British insurers tumbling (Collinson and Osborne, 2014). The policies scrutinized were sold in the 1990s and 1980s and savers were trapped by penalty charges of 10%-12% and in some cases more than 20% if they want to move their money. The first two years of contribution by savers covered commissions earned by salespersons and annual charges were around 4% per year. These policies are still in use and the regulator assured financial firms that no compensation for customers would be imposed.

Informant 1: 'Almost every week we see customers with policies where penalty charges for withdrawing money reach 10% and penalties to transfer money out of about 20%. This is justified with what is called "market value adjuster". Customers are trapped in funds where the annual bonuses have often fallen to zero and where they do not have access to their savings until retirement age'

As for the likely outcome of this investigation,

Informant 2: 'The regulator cannot review the millions of policies individually; it cannot remove exit penalties without an ad hoc piece of legislation; it is impotent when it comes to introducing change in sales practices; cannot apply current standard retrospectively, let alone calling for compensation of savers.'

This case prompts two observations. First, investigations such as this determine a plunge in share values, therefore they are feared by firms as well as customers, with the former pointing out the damaging effects that any attempt at regulation may produce. The status quo, in this view, is less harmful than any sort of external intervention. Second, disappointment and fear by savers may lead competing firms to offer their own services, persuading people to move money out of their pension to their own schemes. Such unsolicited offers of help may hide yet more speculative or even fraudulent purposes.

Libor interest rates

The 'London interbank offered rate' (*Libor*) was involved in criminal activity affecting more a dozen institutions on three continents. Investors were outraged when the scale of the offence was revealed, with Barclays Bank being asked to pay £290m in penalties for moving the exchange benchmarks and thus gaining illicit profits (Ruggiero, 2013). See crimes of the economy... "Three former employees at money broker ICAP are to face criminal charges brought by the Serious Fraud Office in relation to allegations that they were part of a conspiracy to fix Libor interest rates. Accord-

ing to the SFO the offences took place between August 2006 and September 2010, therefore well after the effects of the 2008 crisis came to light' (Bowers, 2014). It is worth noting that Britain, through its own SFO only interned when a similar initiative in the form of criminal investigation had been taken by its US counterpart, thus revealing a climate of competition among countries. Such competition, as this case shows, results in national regulators turning a blind eye to their compatriots' financial criminality and adopting a harsh stance towards that of others.

Co-op Bank

This bank had a £1.5bn deficit in 2013 and was bailed out by hedge-fund investors and the wider Co-operative Group. In 2014, the Bank admitted that it needed a further £400m to balance its accounts (Armitage and Goodway, 2014). Mis-selling of pension schemes and interest-rate-hedging products were certified, as well as breaches of the Consumer Credit Act. Shareholders, largely consisting of hedge funds and institutions, will be required to foot the bill.

The Co-op Group is itself in turmoil after the resignation of its chief executive. The situation has alienated further the ethical investors who have traditionally been attracted to the Co-op Bank's previous collective ownership structure. Some charities began looking for alternative places to bank after the hedge funds became the majority of shareholders. The Co-op Bank confirmed that it has cut 1,000 jobs from its 10,000-strong workforce and closed 30 of its branches. It expects to close a further 15 branches this year.

Informant 5: "The National Audit has warned that a brain drain from Britain's City watchdogs has led to their employing thousands of inexperienced staff. A report published by NAO expresses grave concerns that a third of staff at the Financial Conduct Authority have less than two years' experience while a quarter of leavers from the Bank of England's Prudential Regulation Authority are rated top performers. On the contrary, it would be vital for both watchdogs to attract and retain the right staff to cope with

the challenges arising from the financial crisis. The report stresses the importance of effective oversight of an industry that is valued at more than £234bn. Regulated firms paid £664m in the 2013-2014 financial year to keep their regulators running, 24 per cent more than in the previous year. The increase is said to result from expensive and time-consuming investigations. Therefore, firms can claim that regulation is wasteful.

Lloyds Banking Group

One of Britain's biggest banks has cost victims of the payment protection insurance (PPI) scandal tens of millions of pounds by wrongly cutting their compensation awards. Lloyds Banking Group, which is 33 per cent owned by the taxpayer, has been cutting payouts to victims who were mis-sold the notorious insurance policies intended to cover loan payments if borrowers found themselves unable to work. In many cases, the fine print meant that customers could never make a claim. A taxpayer-sponsored bank depriving taxpayers of their rightful compensation by using a loophole (Harper, 2014).

Informant 7: "The bigger the financial sector becomes, the slower the overall rate of growth. The banking system is the root cause of severe instability. More than three quarters of bank loans are linked to property and this creates a self-fuelling boom-and-bust cycle. The availability of credit pushes up property prices and, as prices rise, it encourages a further round of speculative borrowing and buying – pushing prices up even more and well beyond what is supportable in the long term. When the bust comes, the spiral goes into reverse and the deleveraging causes huge pain throughout the economy. The role of banks in economic textbooks is to provide capital to entrepreneurs to build businesses. That happens very little. Today, the role of banks is to finance speculation in second-hand property. This informant, fund manager, moved to the LSE as a lecturer, and noted that equity returns today are massively less than they were up until the 1990s. His concern is that too much of the money in the system is creamed off by interme-

diaries. Fund managers do what is good for them and for the fund management business, and this is not always the same as what is good for the clients. Bending or mis-interpreting rules leads to momentum investments, which are not proven illicit as yet. But this reduces the business risk while the client suffers from poor performance. Fund managers tried to compensate for poor returns by supporting greater incentives for management to perform – hence the explosion of executive pay and bonuses. But far from encouraging performance, bonuses are making management risk-averse and thereby condemning businesses to decline (managers would not give loans to entrepreneurs). Managers will accumulate enough money to make their family secure for three generations. Short-termism is the key.

Pinto, D. (2014), Capital Wars, London: Bloomsbury (on how finance should set itself long-term goals).

'I expect compromise there. I think banks are actually a little more vulnerable to political backlash in the Usa that they are in Britain. Republicans and Democrats alike counterpose Wall Street (the bad guys) to Main Street (ordinary Americans). I expect a little more regularisation in the US. But despite this, there is a third major difference between now and 1929: the absence now of substantial organized and ideological opposition to capitalism' (Mann, 2011: 13).

So, policies are tailored around the needs of bankers rather than citizens: 'The first need is the security of the investor, and never mind about the result in unemployment. And the banks themselves oppose much regulation. They think they have got the perfect solution already: they make lots of money in good times and when the bad times come they get bailed out and capitalism gets saved. So what could be better for them but worse for us?' (Mann, 2011: 14). A financial crisis caused by neoliberalism turns into more neoliberalism.

Informant 3: Distinction between investment banks and retail banks. Prop (property) banks: packages are still there, and regu-

lators are impotent. No notion of unlawful conduct, but embarrassment about such conduct. No new regulations. Regulators are underfunded: bankers know more and tell regulators what to look into. Waiting for the next crisis (see 'Money'). The sector has a short memory. It's a s if they try to make as much as they can before their conduct is described as criminal. They are too big to fail: we are too important to have definitions unfavourable to us. Nothing has changed.

Informant 4: The more crashes happen, the more people have to imitate unethical conduct, not success. This is the demoralizing effect of....

Campaigners

Tax evasion and avoidance finally came under scrutiny this year.

Despite a number of encouraging breakthroughs on tax dodging in 2013, much work lies ahead if tax justice is to become a reality

Bermuda is among a growing number of tax havens that have agreed to lift the lid on who has money deposited in their banks. Photograph: James Boardman/Alamy

Tax came of age in 2013. No longer the preserve of accountants, it won the attention of governments, parliaments, journalists, campaigners and voters who, according to *one recent British poll*, are more concerned about *tax avoidance* than any other aspect of companies' behaviour.

With so much focus on how rich people and companies dodge their fair share – and with many societies struggling with austerity – it's hardly surprising the international apparatus of tax evasion and avoidance is starting to look threatened.

This year has seen so many breakthroughs that one risk, for those who believe tax justice will change the world, may be complacency. We are still only at the start of a much longer battle about the distribution of power within societies and between countries. We cannot expect the *companies and individuals who have gained trillions* through cheating the rest of us to

let go without a fight.

But with that warning about the need to keep pushing against tax dodging and the financial secrecy that sustains it, here are the four highlights of progress towards tax justice in 2013.

First, after countless exposés of multinationals *such as Starbucks and Google*, which pay little tax in countries where they do brisk business, G8 and G20 governments agreed to investigate how to tackle such obvious unfairness. The rich countries' club, the *OECD*, is *leading the work*, which is supposed to create rules that benefit poor as well as wealthy nations – although the former will have to fight for it.

Since poor countries lose about *\$160bn a year to tax dodging by multinationals*, the likes of Christian Aid, ActionAid, Oxfam, Tax Justice Network and the Global Alliance for Tax Justice *are campaigning for* developing countries to have a voice, and for OECD member states to take that voice seriously.

A second highlight was the G8 and G20 also agreeing that multinational companies must reveal more about their finances, by reporting them on a *country-by-country basis*. This will help tax authorities identify which firms should be further investigated.

Campaigners now have to push for some governments – including the UK's – to accept that these reports should be public, so that everyone with an interest can know more about the companies' tax practices in every country where they operate.

A *European Union decision this year* requiring banks to report on a country-by-country basis should inspire future progress: the same rules should be extended as soon as possible to all industries.

A third highlight has been that some governments acknowledged the dangers of allowing people to *hide their identity* and money behind shell companies, so distancing themselves from crimes such as tax evasion and corruption.

In October, plans were announced for a *public UK register* of the real owners of 3m British companies. The next step is to ensure that others, including UK tax havens such as the British Virgin Islands, do the same. We also need to know who and *what lies behind trusts and foundations*. So

far, most governments seem reluctant to tackle the menace of secret ownership.

Finally, there has been progress towards greater sharing of tax information between countries. A growing number of tax havens – including Singapore, Luxembourg, Bermuda and the Cayman Islands – have agreed to start sharing information about who has money in their banks, by *signing the existing international convention*, although some UK tax havens have done so with a *forest of reservations*. This should help governments, including those of poor countries, to catch up with people who hide dirty money “offshore”.

Building on this, the G8 and G20 countries have finally agreed to work towards automatic information sharing between countries. The “automatic” part means governments can obtain information much more easily than at present. Again, the task now is to ensure that the new system works for all countries from the outset, not just for the rich.

This is an impressive list of advances, which few would have dared forecast even a year ago. It holds great promise for people living in poverty across the world. But what happened in 2013 is just the end of the beginning.

In 2014 and for many years beyond, tax and *transparency* campaigners will need to keep the pressure on governments, simply to ensure that they do what they have already agreed to – in the face of well-funded, sustained opposition.

There are also other problems, such as the tax incentives through which governments give away billions to companies every year, in the hope of attracting foreign investment. Governments need to realise that the unsustainable paradigm of tax competition has created a race to the bottom, in which most of us are losers and all the benefits accrue to multinationals.

I am hopeful about tax justice in 2014. Campaigners are increasingly working together. For example, this year saw the formation of the *Global Alliance for Tax Justice*, an alliance of tax justice campaigners from different countries and regions.

Developing countries’ governments are also increasingly interested in the *potential of tax to fund their public services and reduce their reliance on*

unreliable aid flows – and there are many other dedicated politicians and journalists across the world making the case for tax fairness.

What unites us all are the passion and energy that come from knowing about an injustice that we can and must put right.

What the Wolves of Wall Street can teach us about risk

Simplifying the financial system is the only durable way to minimise risk.



This image released by Paramount Pictures shows Leonardo DiCaprio as Jordan Belfort in a scene from “The Wolf of Wall Street.” Photograph: Mary Cybulski/AP

“What a commentary on the state of twentieth-century capitalism,” mused “motivational speaker” Jordan Belfort as he looked back on his life of fraud, sex, and drugs. As head of the brokerage firm Stratton Oakmont, he fleeced investors of hundreds of millions of dollars in the early 1990’s. I saw Martin Scorsese’s film *The Wolf of Wall Street* and was sufficiently intrigued to read Belfort’s memoir, on which the screenplay is based. I learned quite a lot.

For example, the scam known as “pump and dump,” which netted Belfort and his fellow Strattonites their ill-gotten gains, comes into much

clearer view in the memoir than it does in the film. The technique works by buying up the stock of worthless companies through nominees, selling it on a rising market to genuine investors, and then unloading all of it.

It was not just small investors who were ruined; what stands out is the greed and gullibility of the rich who were sold the same rubbish by the “young and stupid” salesmen Belfort preferred to hire. Belfort was (is) obviously a super-slick snake-oil merchant, brilliant in his trade until drugs ruined his judgment.

Belfort, once again selling the elixir of success after a brief stint in prison, professes to feel shame for his behavior; but I suspect that deep down his contempt for those he swindled outweighs any sense of remorse. In a recent book, *Capital in the Twenty-First Century*, the economist Thomas Piketty describes Stratton Oakmont as an example of “meritocratic extremism” – the culmination of a century-long passage from the old inequality, characterized by inherited wealth and discreet lifestyles, to the new inequality, with its outsize bonuses and conspicuous consumption.

Belfort has been described as a perverse Robin Hood, robbing the rich to give to himself and his pals. The rich were the old-money Protestant establishment whose members had lost their skills for protecting their wealth, which was therefore rightfully forfeited to street-savvy up-and-comers – mainly Jewish – amoral enough to help themselves to it. But Stratton Oakmont’s peculations were hardly an exception on Wall Street. As a good friend, who was an SEC regulator for 20 years, told me when I asked about the extent of fraud, “I found it to be pervasive. The system simply makes it too easy, and human nature colludes on both sides. Greed is the source of all cons.”

The Wolf of Wall Street was a predator, but so were all those reputable investment banks that shorted the products they were selling, and the retail banks that offered mortgages to unviable borrowers, which they could then repackage and sell as investment-grade securities. They were all wolves in sheep’s clothing.

A decent banking system has two functions: to look after depositors’ money and to bring together savers and investors in mutually profitable trades. Savings are deposited with banks because they are trusted not to steal them, and custody has a price. The deals that banks arrange between

borrowers and lenders are the lifeblood of modern economies – and risky work for which bankers deserve to be well rewarded. But any money that bankers earn over and above the cost of compensating them for providing an essential service represents what former British regulator *Adair Turner* calls “social waste,” or what used to be described as “usury.”

It is not the extent of the financial system that should alarm us, but its concentration and connectivity. In the United Kingdom, an ever-increasing share of bank assets has been concentrated in the five largest banks. Standard economic theory tells us that excessive profits are the direct result of concentrated ownership.

Connectivity is the link between banks. These links can be locational, as in Wall Street or the City of London. But they became global through the development of derivatives, which were supposed to increase the stability of the banking system as a whole by spreading risk. Instead, they increase the system's fragility by correlating risk over a much larger space.

As a paper by Andrew Haldane of the Bank of England and the zoologist Robert May points out, derivatives were like viruses. Financial engineers and traders shared the same assumptions about the risks they were taking. When these assumptions turned out to be false, the entire financial system was exposed to infection.

Concentration and connectivity reinforce each other. Two-thirds of the recent growth of banks' balance sheets in the UK represents internal claims among banks rather than claims between banks and non-financial firms – a clear case of money breeding money.

Reformers want to cap bankers' bonuses, create firewalls between banking departments, or (more radically) limit a single bank's share of total banking assets. But the only durable solution is to simplify the financial system. As Haldane and May put it: “Excessive homogeneity within a financial system – all the banks doing the same thing – can minimize the risk for each individual bank, but maximize the possibility of the entire system collapsing.” As long as banks can make a profit from trading, they will continue to expand derivatives in excess of any legitimate hedging demands from non-banks, creating redundant products whose only function is to make profits for their inventors and sellers.

How to curtail derivatives is now by far the most important topic in

banking reform, and the search for solutions should be guided by the recognition that economics is not a natural science. *As May recounts*: “The odds on a 100 year storm do not change because people think that such a storm has become more likely.”

In financial markets, the odds do depend on what people think. The less thinking they have to do, the better. Jordan Belfort was partly right: people who go into finance should not be too clever.

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Conclusion

‘Statutory regulation and supervision draw legitimacy from the assessment that certain activities have significant effects on the economy as a whole and that these external effects are not sufficiently taken into account in private decision making and private contracting. For the banking industry, the externalities arise from the systemic implications of bank breakdowns. If a bank goes under, systemic repercussions can cause damages that exceed anything the managers of the bank could have considered. If the government steps in to contain their systemic repercussions, the damage may be contained, but the cost to the taxpayer may still be substantial. Statutory regulation and supervision should be designed to mitigate these problems. This very rationale for statutory regulation and supervision implies that there must be a conflict of interest between bankers and bank regulators. If regulation is there to force bankers into modes of behaviour that they would not choose otherwise, the bankers are bound to resent the intervention. Given this resentment, they will protest the infringement of their freedom of action and the loss of competitiveness that the regulation imposes on them’ (Hellwig, 2010: 17).

‘We need to appreciate that a bank’s private interest in managing its risks is not the same as the public interest in having banks manage its risks so as to avoid systemic damage. If they were the same, we would not need any regulation at all. We cannot do very much, so we hear, because regulation in one country gives a competitive advantage to other coun-

tries. Banks loaning funds to low income families did not perform a public service, but were engaged in private profit making. 'By portraying this profit-making activity as a contribution to social policy, the participants merely diverted attention away from real public concerns' (Hellwig: 18).

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