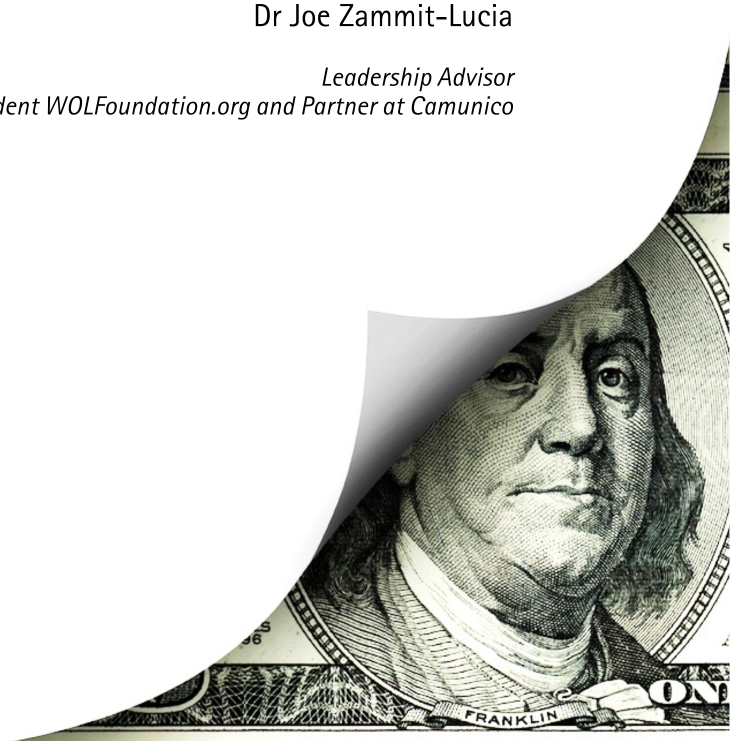
The Social Value of Financial Services

A paper to stimulate discussion

prepared by

Dr Joe Zammit-Lucia

Leadership Advisor
President WOLFoundation.org and Partner at Camunico



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Only people this sophisticated could create a mess this big

Brazilian joke at Argentine superiority complex

- In a capitalist society, finance lies at the heart of the proper functioning of that society
- A breakdown of the financial system therefore threatens the very foundations of our society
- We are currently in the midst of such a breakdown – a breakdown that has not been averted – and will not be averted – simply by ensuring the survival and financial stability of existing institutions in their current form.
- Do we need to go much further to return the financial services industry to its proper functioning at the heart of our societies?

While recognising the immense social value that finance can create, a recent article in The Economist also warned:

> *"Yet finance can also terrorise. When bubbles burst and markets crash, plans paved years into the future can be destroyed. As the impact of the crisis of 2008 subsides, leaving its legacy of unemployment and debt, it is worth asking if the right things are being done to support what is good about finance, and to remove what is poisonous."*

This paper has been prepared to stimulate discussion at the Salon evening planned for the 12th of June in Amsterdam. This paper is intended to provide some perspectives on the broad issues and bring together some of the key areas of discussion. In parts, it is also intended to be somewhat provocative.

"Finance has the power to terrorise"

The issues to be considered are complex and have been the subject of much thinking and action by many people. This paper is not intended to provide 'solutions' – if such even exist. Rather it is intended primarily to raise questions and to provide a set of viewpoints around which we might have an interesting exchange of ideas during the Salon.

Finance is Crucial to Society

The financial services industry has a core social function – that of ensuring that capital flows smoothly to all the important parts of an enterprise society thereby enabling investment, growth and financial security for all. In addition the industry also has a key role in risk intermediation. It is clear to us all that the financial services industry is not currently performing these functions effectively and, in its current form, may not be able to return to performing them adequately.

The Loss of Core Purpose

Has the financial services industry has lost sight of its core purpose?

For our society to perform adequately capital needs to flow smoothly across the whole of the real economy and it needs to do so at minimum frictional cost. This provides all parts of the economy with investment opportunities and also gives individuals at all levels of society the earning potential and financial security they deserve. This can only be achieved through a healthy, well-functioning financial services industry that has a single minded focus on its core social purpose.

Here are a few of the many reasons why this core purpose is not being fulfilled:

- Firms operating in the industry have shifted their primary purpose from the one outlined above to a focus on maximising their own and their shareholders' wealth. This has a number of implications:

    - the frictional costs of capital flow have risen dramatically as oligopolistic firms capture for themselves an ever-increasing proportion of the value provided

    - risk and social costs are multiplied as dominant firms and their shareholders are rewarded for high short-term profits while being shielded by taxpayers' money from the downside risks

    - in order to maximise profits, firms give preference to those who already own capital (their biggest clients) at the expense of those who do not (eg. 'insiders' get preferential access to attractive IPOs)

    - attempts to minimise risk and maximise profits lead to capital being available to those who do not need it rather than to those who do (Apple, with hundreds of billions of cash sitting on its balance sheet can raise further billions in low cost debt while SMEs struggle to access investment capital at reasonable rates)

  - products are designed with the sole purpose of delivering profit to firms even if they destroy social value (eg. tax arbitrage products arguably destroy social value but deliver profits to firms; the conversion of 'carbon trading' from a socio-environmental product to a financial product has, arguably, resulted in significant social damage)

  - there is little or no capital available for socially valuable investment that only delivers value over longer time periods (eg. investment in environmental remediation)

- Different regulatory bodies each have their own narrowly circumscribed set of responsibilities making it difficult for any one body to take responsibility for addressing the functioning of the financial system as a whole

- The unhealthy mix of globalisation of financial services coupled with local regulation allows the handful of firms that control much of the industry in each country to resist attempts at meaningful reform of the system in their own country by positioning it as a threat to their global competitiveness. The local political power of such firms combined with the impossibility of achieving world-wide agreement on any significant change results in the current system remaining embedded and largely unchangeable

Politically powerful financial institutions can frustrate change

- The 'greed is good' culture of the 1980s and 90s has not yet been effectively extirpated from the system

Issues do not seem to be limited to the banking sector. Pension and insurance firms have their own issues.

Towards a Better System?

Some significant progress has been made since the financial crash of 2007-08. However, such progress remains patchy and each step is slow and painful.

Capital requirements for banks have been increased and a slew of new rules have been adopted. It is notable that progress has been much more rapid in the US than in Europe – in terms of capital requirements, the separation of investment from retail banking, and the limits on banks' ability to trade for their own account. However, even these changes have been blunted significantly due to industry lobbying.

In Europe, attempts at banking union in the Eurozone remain painful with many countries defending their national interest and Germany in particular resisting any meaningful mutualisation of risk. This will likely result in a partial union with an insufficient backstop and complex resolution procedures that remain politicised and that may or may not work in practice. One commentator in the Financial Times describes the proposed banking union as 'deadly' because, in the name of expediency, important principles have been sacrificed and rules will be phased in piecemeal. Further it is unlikely that Eurozone banks will be asked to raise the approximately €1trn necessary to make the system resilient to the next financial crash.

The separation of risky investment banking practices from the more stable, but less profitable, retail banking has largely not happened. Neither is it clear that the Eurozone banking union as currently proposed will be effective in separating bank failures from sovereign risk. Further, risk has been transferred on to helpless ordinary savers as 'bail-ins' seem to have become an accepted tool to provide a measure of protection to sovereigns from bank failure.

Other steps have been taken. In some countries, small and politically captured institutions (such as the Spanish Cajas) have been consolidated or absorbed into larger entities. While this is a positive development in terms of improvement in management quality and ability to carry risk, it is not clear whether, in the longer term, it will improve or diminish SME access to capital.

Is the next crash already in the making?

Mortgage lending and the securitisation of loans was an important cause of the financial crash. Here it is tricky to achieve the right balance between maintaining broad access to capital and avoiding another bubble. In some countries (eg. the Netherlands) access to mortgage capital remains tight. In others (eg. the UK) the next bubble is already visible.

However, in spite of all these changes, there is little evidence of any fundamental change in the fundamental behaviours of financial services firms – either in Europe or in the US.

Overall, many commentators have suggested that we have not seen sufficient change in the financial sector either to avoid another financial crash or to be able to deal with it any more effectively when it happens.

The Firm as the Locus of Change

One view is that real change will not happen unless it can start at the level of the individual firm. Regulators have an important role to play in pushing for such change and in creating the environment for change using both their hard and soft powers. However, regulators' efforts are likely to become diluted or even totally frustrated if firms with political and market power are not ready to embrace change.

At a recent conference on 'inclusive capitalism', Christine Lagarde said that behaviour in the financial industry *"had not changed fundamentally in a number of dimensions since the crisis"* and that there was *"fierce industry pushback"* against a number of necessary reforms.

Is meaningful change at the level of the individual firm possible? While some have given up any hope of such change, others have embarked on various initiatives designed to start the process of change.

Can "Culture Change" Work?

"Culture Change" has been a buzzword in the business world for decades – having been pushed by consulting firms and business schools as the solution to almost any systemic issue. Yet most culture change programmes are notable only by their failure.

In the financial services industry, banks from Deutsche Bank to Barclays have embarked on significant culture change programmes. Their efforts, which we assume to be genuine, have tended to falter. At Barclays, barely a year after a new CEO announced a 'transformation programme', the bank finds itself embroiled in a brawl with government and shareholders over a 10% increase in its bonus pool in the face of profits dropping 32%. While intentions are doubtless good, Barclays is a good illustration of the difficulty, if not impossibility, of implementing major culture change programmes in parallel with the formidable task of turning around what is essentially a failing bank.

'Culture Change' programmes will likely not succeed

Signals from the top can also put the knife into any attempts to instil ethical behaviour into a firm. JP Morgan Chase CEO Jamie Dimon was awarded, as the New York Times puts it, '$20 million — a 74 percent raise — for 2013, a year in which JPMorgan narrowly escaped a criminal guilty plea and paid more than $20 billion in regulatory fines and penalties?' This can be interpreted as a clear signal to all the bank's staff that the firm's profits remain paramount and staff will be rewarded for achieving them even if they do so illegally.

We suggest that culture change programmes as traditionally undertaken will not be successful in transforming either individual firms or the industry. Major culture change programmes announced with much fanfare can undermine the credibility of senior management and do more harm than good. Similarly, the large increase in rules based regulation that we are seeing may make it more difficult to achieve real change as management inevitably becomes ever more focused on maintaining performance in the face of increasing compliance requirements.

Rather, we all understand that change is a slow and painstaking process that:

- requires concerted and sustained effort over long periods

- must be aligned with the firm's strategic and operational changes over time rather than being a high fanfare programme emanating from the C-Suite. One cannot expect behaviour change if the purpose and basic business of the firm have remained unchanged.

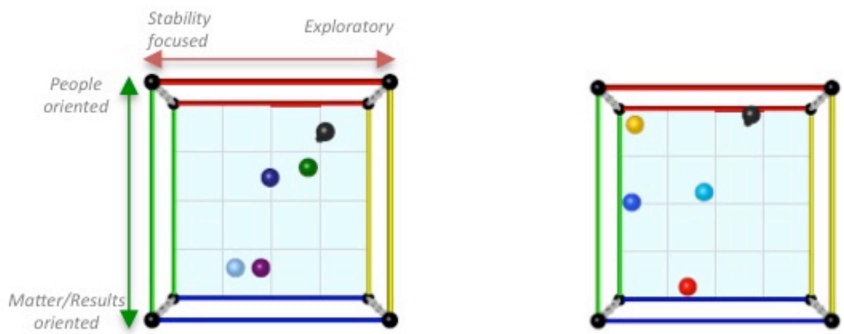
- must be able to run in parallel – and enhance rather than interfere with - the realities of maintaining or restoring the financial health of institutions.

Behaviour change is a multi-year effort that requires as much perspiration as inspiration. Here we put forward questions that management and regulators can discuss and debate as they look towards building the future of the industry.

Always change a winning team?

Einstein famously stated that we cannot solve problems using the same thinking that created them. Similarly, it can reasonably be argued that systemic change cannot be achieved with the same people and teams that built the current system.

Traditionally, senior leaders have picked their teams on the basis of technical expertise and past success. But this approach may be a guarantee of failure to achieve meaningful change over time. Neither can leaders afford only to look at the competencies of individuals. Many great individuals can easily come together to form a poor team (All Star teams rarely succeed in sports).



Team 1: Good balance likely to be able to achieve change over time

Team 2: Poor balance. Unlikely to be able to drive change

Source: Camunico

What are we?

In an article in the Financial Times (12 February 2014), John Gapper argued that:

> *"...there is no such thing as a banker. There are equity brokers, foreign exchange traders, mortgage salespeople, corporate financiers and all kinds of specialists under one roof. There is no single set of employees unified by a professional culture and a willingness to pull together."*

There is truth in this statement. And it makes the process of change that much harder. It also means that these different sub-cultures need to be treated differently and each needs to be led by teams that can intermediate between the competencies and behaviours of these different groups and the overall direction of the firm.

Does maintaining large financial institutions serve the public interest?

Of course, another alternative is that regulators take the view that it no longer serves the public interest to allow the existence of over-large organisations housing all these different specialists under one roof with the inevitable clashes and conflicts of interest. This puts the need to create more manageable firms focused on customer needs with the need to ensure financial stability – supposedly something that requires scale.

Rules don't work - much

Rule based regulation (whether internal to the firm or externally imposed by regulators) will, of course remain an important part of improving the functioning of the system, working towards ensuring financial stability, etc. However, it is as well to recognise the significant limitations of rules.

First of all, many rules are backward looking ie. they are usually directed at solving problems that have arisen in the past. The process of identifying problems, creating rules and then implementing them is necessarily slow so that, unless the rules are structural, by the time they are implemented much has moved on in the marketplace and the effectiveness is blunted.

Smart people will find their way around the rules

Secondly, banks have always sought to employ smart, driven and creative people – especially in the more speculative and risky parts of their business. When management or regulators try to hem in the behaviour of such people through a set of rules, there is only one outcome – employees' energy and creativity become directed towards finding a way around the rules. Generally they are successful.

For management this may mean that they cannot keep employing highly creative people while expecting them to operate strictly within the tramlines created by the new rules. Both individuals and teams need constant re-alignment over time and across different business lines as more or less rules are put in place.

For regulators, the limits of rule-based regulations are obvious – and have been for a long time. Given that reality, to what extent should regulators be making greater use of their soft powers rather than their formal ones?

Are regulators good role models?

Do regulators themselves set a good or a bad example?

Regulators may be setting the wrong example

Europe is now faced with the situation where the German Constitutional Court has ruled the ECB's Outright Monetary Transaction programme as being incompatible with Germany's primary law. The programme was declared *ultra vires* and in violation of EU treaties. In addition, the German court finds the purchase of sovereign bonds in the secondary market simply to be a "circumvention" of the explicit legal prohibition against state financing.

What does this mean? Are these courageous and effective moves by the ECB or are these simply bankers behaving true to form and continuing to reinforce a culture that believes that there is no rule that clever people cannot find their way around to achieve their ultimate aims?

Does rewarding employees damage firms?

Bankers' compensation and bonuses for reaching clearly defined profit goals have become a lightning rod for criticism of the financial services industry. Are such compensation schemes justified and do they improve the way the financial services industry discharges its social function?

Management usually justifies high compensation on two levels:

1. As outlined earlier, it is put forward as necessary to maintain international competitveness
2. Reward for performance is considered necessary both to attract and to motivate people

Here are the results of some studies:

- A study done at MIT, Carnegie Mellon and the University of Chicago on behalf of the Federal Reserve Bank of Boston concluded:

  "In eight of the nine tasks we examined across the three experiments, higher incentives led to worse performance."

- Scholars from the London School of Economics analysed fifty-one studies of corporate pay-for-performance plans. They concluded:

  "We find that financial incentives . . . can result in a negative impact on overall performance."

- Many scholars led by Theresa Amabile from Harvard Business School have concluded:

  "extrinsic rewards can be effective for algorithmic tasks—those that depend on following an existing formula to its logical conclusion. But for more right-brain undertakings—those that demand flexible problem solving, inventiveness, or conceptual understanding—contingent rewards can be dangerous. Rewarded subjects often have a harder time seeing the periphery and crafting original solutions."

- A group of scholars from the Harvard Business School, Northwestern University's Kellogg School of Management, the University of Arizona's Eller College of Management, and the University of Pennsylvania's Wharton School conclude from their research:

Should regulators be bolder in controlling compensation?

> *"Substantial evidence demonstrates that in addition to motivating constructive effort, goal setting can induce unethical behavior."*

Given these realities:

- how can management break out in practice from the remuneration based culture currently prevalent in many sectors of the industry?

- could regulators afford to be bolder in regulating compensation?

Are backstops benign or corrosive?

Maybe one of the most difficult issues that regulators have to face is how to ensure financial stability.

Since the 2008 crash, most countries have responded by increasing the number of rules and by increasing the amount of backstop financing available for the next financial crash. We have already argued that rules have limited effectiveness. Increasing the backstop makes them even less effective by further removing penalties for excessive risk taking.

Have we entered a corrosive cycle that guarantees repeated collapse?

State guarantees for the activities of financial services firms permeate every pore of the system. This leads to massive flows of 'blind capital' seeking higher rewards through excessive risk taking. Yet governments' responses to every financial disaster since the 18th century have always been the same – a combination of more rules and increased protection for the industry. Why are we unable to break out of this cycle that does very little except ensure repeated periods of collapse?

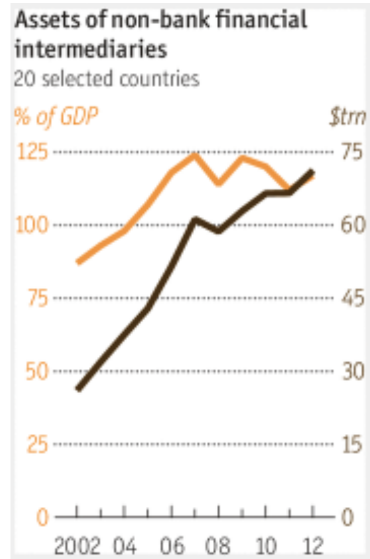
The reality is that while policy makers continue not only to tolerate but actively to subsidise large financial institutions that pose systemic risk, no meaningful change is likely to be possible.

> *"the rationale for the rules and the rescues has been to protect ordinary investors from the evils of finance. Yet the overall effect is to add ever more layers of state padding and distort risk-taking."*

Does part of the answer lie with alternative finance?

If banks, and their regulation, cannot provide the answers, does part of the solution lie in alternative financial institutions?

The past several years has seen a rise in alternative finance institutions – also known as 'shadow banking.' From insurers to pension funds to large retailers to peer-to-peer lenders and private bond issuers, these alternative institutions are increasingly providing alternatives to financing by mainstream banks.



Regulators have, so far, shown caution around such institutions as they are not as 'well-regulated' as banks. Many will see a humorous irony in such a statement. Maybe alternative finance institutions presents an opportunity rather than a threat and regulators should not be keeping them down through excessive caution.

We would suggest that, in evaluating the future of alternative finance institutions, regulators could focus on two issues:

- Encouraging their growth as a way of diminishing the systemic risks associated with over-concentration of the large banking institutions
- Limit regulation to a few key areas:
    - Banning or significantly limiting leverage
    - Constraining the areas of operation of any one institution to avoid the creation of yet more large, diversified institutions that will once again pose systemic risk
    - Ensure that such institutions receive no State guarantees in the event of failure
    - Making the lack of State guarantees clear to consumers to encourage appropriate due diligence

Conclusions

We are all left with a number of questions:

- What really is the purpose of the financial system? It's not just about efficiency.
- What should, therefore, be the role of financial regulators and ministries of finance?
- How profound a change is needed? Does tinkering at the edges work or does it do more harm than good?
- How much can the Netherlands achieve and how? Who has the courage and capability to achieve it?

A healthy financial system is crucial to the success of any capitalist economy. Finance therefore has a vital social function to play. Yet many financial institutions seem to have lost sight of their core social purpose. As a result, we have developed a system that is destined to suffer repeated financial collapses and may be unable to provide financing for those initiatives that deliver the greatest amount of social good.

The interaction between finance, regulators and the political system is complex and difficult to unravel. Yet, failing some bold leadership both within individual firms and on the part of regulators, it is difficult to imagine finance returning to its rightful pace as a trustworthy, reliable and valuable pillar of our societies.