

Does financial reform entail real change? For whom, by whom and how?

Comments on the report by Domenico Siniscalco

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1. Preliminary

- (1) The report by Domenico Siniscalco is rich and thought provoking, we ought to be thankful to him for this work. The quantitative appendix – despite its density – provides an up-to-date picture of many of the highly technical aspects of the financial system.
- (2) My comments will focus on three issues related to the report, but more generally to the question in the title of this session: “Does the financial reform entail a real change? For whom, by whom and how? ”
- The first point relates to the still missing “audit” of the deeper causes of crisis” ;
 - The second addresses the lasting extra-financial consequences of the post-crisis rescue packages and suggests, following the Pope Francis, that “reform” should be more ambitious than just the financial stabilisation – in the narrow sense;
 - The third point is about what remains to be done in order to make the world economy more resilient to future financial crises.

2. The “audit of the crisis” is long overdue

- (3) D. Siniscalco raises the point from the outset of his paper and one cannot agree more: almost nine years down the road, an agreed and comprehensive diagnosis of the financial crisis and of its spill-overs on the world economy is still missing. This being said, because of deep methodological and ideological disagreements, such a shared diagnosis will probably never be achieved.
- (4) The diagnosis of the direct, technical causes is rather consensual and these causes are well documented (excessive appetite for risk, excessive leverage, unsuspected consequences of interconnectedness, and weak inappropriate trans-border regulatory framework). Two out of four of these direct causes have been addressed, at least to some extent, as shown in the paper.
- (5) Beyond direct ones, two other sets of causes are less consensual. The Pope puts them at the heart of his writings. The first of these sets concerns the reasons why the world economy discovered itself so vulnerable to the crisis. Why and how finance has been allowed to become so systemically important to hijack the world economy at the moment of crisis? Why the world economy has become so highly “finance-dependant” not to say addicted to finance? The second series of non-consensual causes regards deeper, and more intimate, aspects of the functioning of the financial sector such as skewed worldview, flawed culture and incentives etc.
- (6) Depending on the diagnosis, and the corresponding list of causes, the reform agenda will be different. “Repair, Reform or Recast?” was a question articulated very early on by OECD. The G20 declaration after the London meeting (2009) could have been a starting point for a broad diagnosis and a subsequent road-map with recast-like a to-do list. The programs drafted – in 2009 – had with a clear sense of urgency and the explicit aim not only to stabilise but also to overhaul in a comprehensive manner the economic and financial system with a special attention to the developing world. The annual Report of BIS (2009) has prepared the group by setting out a list of causes that have to be addressed urgently: on the macro level, the reduction of international & public imbalances (deficits) and the end of artificially low interest rates (which made the world more finance dependent in decades preceding the crisis), and overhaul the inadequate regulation; on the micro level, reviewing the incentives, giving space prudent and informed judgment of finance management, increasing the role of proper risk assessment within the

industry. But after 2009, from one G20 meeting to the next, steam has been taken away from the recast approach and consensus seemed to be moving towards a repair view. Today programmes are focusing mainly on stabilisation¹.

- (7) In *Laudato Si*, the sentence which follows immediately to one quoted in the programme of our Malta meeting, the Pope says (para 189): *“The financial crisis of 2007-08 provided an opportunity to develop a new economy, more attentive to ethical principles ... But the response to the crisis did not include rethinking the outdated criteria which continue to rule the world.”* Has the window of opportunity provided by the crisis to make the world economy less asymmetric and unequal been lost? Possibly, yes.
- (8) That paper under discussion gives to the notion of “financial reform” a narrow sense of “financial stability”. Only toward the end of his paper, the author reaches the critical question “is stability the sufficient feature ... or stability is a necessary condition and should we aim at other objectives?” This question gives me the opportunity for looking at other aspects left aside by this narrow definition.
- (9) Of course, financial stability was, and still is a goal, but it stands short of a long term perspective. It is a reactive policy, not pro-active one. Pro-active stabilisation efforts would make sense only after agreement has been reached that the system – in its present state - is worth repair. But until today such an explicit agreement is not reached. In fact, the world lives under the threat of a new crisis, desperately waiting for growth. In this situation, it is not able, or not willing to take a long term view without which a reform is impossible. The last time this happened was in 1944, in Bretton Woods.
- (10) Indeed, stabilisation is not normalisation. Before normalisation can be achieved, we need an agreement on the post-crisis mandate for a financial system serving the Common Good. The question is political and social. It touches the very purpose (or mission) of the financial sub-system as part of a larger social system. What services the rest of the society expects finance to provide and at what conditions? Indeed, if finance is to be seen as a “public good” in the sense of its contribution to the Common Good of humanity, its mandate has to be clarified. What is the required / optimal blend of the three core functions of finance: payments, collection of savings and prudent funding of healthy projects, and risk

¹ For a more comprehensive treatment of these issues see Dembinski, Paul. & Beretta, Simona, « Beyond the Financial Crisis : Towards a Christian Perspective for Action », Report for Caritas in Veritate Foundation, Geneva, 2014, 100 p – free download www.obsfin.ch and www.fciv.org

management? During the three decades preceding the crisis, financial sector grew mainly in its risk management function – precisely what the Pope calls “speculative practices and virtual wealth”. As long as these functional priorities – and corresponding regulatory instruments – are not articulated and enforced, stabilisation efforts will remain purely reactive, as they are today. But who really wants today to push on such an agenda? Financial industry is opposing it, NGOs are too dispersed, governments paralysed. A strong – prophetic - leadership is missing both at EU and world levels.

3. The long term de-stabilizing consequences of short term stabilization packages

- (11) Rescue and stabilisation packages discussed in the paper were mainly aimed at solving the most urgent problems and preventing the collapse. They succeeded in preventing the systemic risk from materializing, but also brought with them heavy collateral effects which seem to be long-lasting. The world after 2009 is deeply different from what it was before the crisis. Even if the banking sector seems stronger than before, it is still heavily dependent on central banks’ liquidity provision and interest rate policies. The same is true for the financial markets which operate in “unconventional situations” which may set the ground for next bubbles. As time flies by, and the financial and economic fragility is not lowering, the low-rate environment becomes the new normality. In other words, **stability may have been (temporarily) achieved but not normalisation**. Possibly some risk has been taken away from banks but it did not disappear from the system as it has been transferred to the pension funds and insurance sector where duration and interest mismatches are continuously deepening.
- (12) At least four other worrying collateral consequences can be attributed to long lasting low interest rate environment:
- (a) the growing risk of asset bubbles (real estate and equity markets) as liquidity and savings in search for returns flow there;
 - (b) the fact that central banks with hugely inflated balance sheets are at the limits of their capacity to face another sudden turmoil;
 - (c) continuous growth of shadow-banking where more and more financial activity – including lending – is transferred (including by banks) because of less stringent regulatory framework;

- (d) continuous growth of overall debt (public and private non-financial), encouraged by the very low interest rates, which has grown since 2009 from 230% of GDP to 260% (BIS, AR 2015, p8).
- (13) Last but not least: the rescue packages for banks have not – as to now – had any significant impact on extending the banks' lending to the real economy. Part of the explanation may be found in the overall economic situation which does not encourage enterprises to borrow, but this is only part of the story, the rest is banks unwillingness to lend as they are concerned with deleveraging and prefer to focus on commission based, as opposed to interest based, business. This observation puts in question the capacity of the financial system in its present shape to play its macro-economic role of an efficient allocator of capital to the real economy. Indeed, when faced with the alternative of investing in a non-listed company (lending or own capital funding) or buying shares, the latter is chosen in most cases.
- (14) In less than a decade the financial landscape has fundamentally changed for most of the players of the financial game. So to the question “did the crisis and reform entail a change?” the answer is yes, but not necessarily for the better when compared with the pre-crisis situation:
- (a) High-grade borrowers have clearly gained, they face lower rates and are able to access the market directly – disintermediation;
 - (b) Smaller and lower-grade borrowers, face apparently high spreads and credit rationing;
 - (c) Ultimate savers, have either to take lower returns or higher risks;
 - (d) Financial intermediaries are under increased pressure to consolidate and restructure. The sector seems to slowly start to shrink.
- (15) Is the world safer today than it was in 2005? Not sure – “stabilisation” has helped transferring massively financial risks from the intermediaries (banks) to ultimate savers who do not have the proper knowledge and lack the systemic leverage. They will not, beyond any doubt, be rescued in case of a sudden asset melt down for which the macro-conditions are set by the near-zero interest environment.

4. Making the world economy more resilient to financial crisis – what remains to be done?

(16) In order to make the world more resilient of future financial crisis, the dependence on financial activity has to be reduced by adequate regulation and framework conditions. Some of the issues listed below belong to the more controversial part of the diagnosis of the crisis referred to above. They have been discussed in previous meetings of the Group of Dublin, so I will not elaborate on them:

- (a) Reduce the size and complexity of the financial institutions and system – these moves or ideas are strongly resisted by the big players, and – in many cases – by the corresponding governments to whom big national banks are flagships of economic power and intelligence. The reduction of complexity is essential for two reasons: quality of supervision and regulation and increased competition within the system.
- (b) Extend regulatory perimeter to the growing sector of shadow-banking and over-the-counter dealings – including black-pools.
- (c) Reduce the volatility which generate nervousity and changing levels of risk and bring it in line with the needs of the real economy. Why should we not come back to the hourly fixings?
- (d) Address – i.e. monitor - the culture of the financial industry and enhance the role of personal responsibility and ethical awareness (see the Dutch example). These issues start to be recognized by the regulators (IMF, FCA) but the resistance of the industry is strong (FCA has dropped in January 2016 a study on culture in banking). This also requires a re-examination of teaching material and methods in economic and finance at university and business-school level. Here also, the resistance of the academic establishment is strong.
- (e) Persistent low, nil or negative interest rates announce a possible asset erosion, or even meltdown, which might lead to chaos. As a significant portion of debt (public and private) – inoextrably raising – is or will prove shortly unbearable, would it not be wiser to initiate a world-wide programme of debt-restructuring?