Finance Watch

Making finance serve society

Finance Watch response to the public consultation on the Europe 2020 strategy

Brussels, 31 October 2014

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

Finance Watch is independently funded by grants from charitable foundations and the EU, public donations and membership fees. Finance Watch has received funding from the European Union to implement its work programmes. There is no implied endorsement by the EU or the European Commission of Finance Watch's work, which remains the sole responsibility of Finance Watch. Finance Watch does not accept funding from the financial industry or from political parties. All funding is unconditional, vetted for conflicts of interest and disclosed online and in our annual reports. Finance Watch AISBL is registered in the EU Joint Transparency Register under registration no. 37943526882-24.

Finance Watch

Making finance serve society

Preliminary remarks

In its Communication "Taking stock of Europe 2020 strategy for smart, sustainable and inclusive growth", the European Commission outlined its efforts to overcome the latest financial and subsequent economic crisis, including its efforts to improve financial regulation, stating that "any review of the Europe 2020 strategy must take account of the financial and economic crisis of recent years and the EU's response to it".

Finance Watch agrees that **significant efforts have been made** to make the financial system safer. Nonetheless, **much remains to be done to make the financial sector fit for purpose** to support the ambitious economic and social goals of the Europe 2020 strategy in a sustainable manner.

Because it is central to the functioning of our economy, the financial sector plays a crucial role in shaping Europe's future across different policy areas; in turn the goal of **creating a safe and sustainable financial system that faces the real economy should be an integral part of the Europe 2020 strategy** in order to achieve maximum results, in particular in view of the European growth strategy post-crisis.

On the other hand, there is a large consensus that **reducing inequalities** would contribute to restoring growth and, as such, the reduction of inequalities should be part of the metrics monitored in the context of the EU2020 strategy.

Without referring to specific questions, **this paper focuses on the second part of the European Commission's questionnaire on EU 2020 strategy**, in particular making suggestions about how to complement the strategy and monitor its progress. It also reflects on civil society's involvement when it comes to monitoring the financial system's ability to support broader societal and economic objectives. Our response is structured as follows:

(1) The first part shows – based on evidence – that the financial sector as it stands is not fit for purpose.

(2) The second part explains why Finance Watch believes that, despite great efforts in the past years, the financial regulations that have been adopted or are in the making do not yet address the major risks and misallocation of resources in the EU financial sector. It also reflects on what features should be present in a financial system that serves society.

(3) The third part suggests ways to integrate these crucial issues into the EU2020 strategy to support its objectives.

Finance Watch

Making finance serve society

1. Challenges: the financial sector - as it is - cannot support the EU2020 objectives

We do not consider the current focus of the European financial sector to be well aligned with EU2020 objectives.

As the Commission puts it, "seeking to return to the growth "model" of the previous decade would be both illusory and harmful", explicitly including in the features of this model "dysfunctional financial systems". Financial systems as they stood before the crisis were dysfunctional. Some prudential progress has been made since then but we would argue that they are still far from fulfilling their core social and economic purposes.

A drag on the economy

Most advanced economies have an overdeveloped financial sector. [1] This has negative consequences on growth and acts as a drain on human resources and capital from the real economy.

The EC wrote: "…the implicit subsidy [to too-big-to-fail banks] makes the financial sector artificially more lucrative and this leads to increases in the size of the financial sector diverting resources (including human capital) from other sectors of the economy."[2] At the same time, "there is a threshold beyond which a larger financial sector [i.e. employing more of the labour force] becomes a drag on productivity growth".[3]

In advanced economies, a growing financial sector is now correlated with weaker GDP growth. Research from the OECD shows that "each percentage increase in the share of finance in total value added is associated with up to 0.12% slower growth".[4]

Other studies have shown that financialisation has a detrimental impact on other metrics, e.g. increased income inequality and unemployment.[5] Widening income inequalities were particularly identified at the 2014 Davos summit as one of the key causes for weak aggregate economic demand and an issue to address.

---

[1] See FW's factsheet on the link between finance and growth: http://www.finance-watch.org/ifile/Events/141105_Event/Finance-Watch-Factsheet_What-finance-for-what-growth.pdf

[2] Impact Assessment Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU Credit Institutions and the Proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions /* SWD/2014/030 final *, Annex 4.2.4.

[3] Cecchetti S. and Kharroubi E., July 2012, BIS Working Paper 381, 'Reassessing the impact of finance on growth', using data from 21 OECD economies 1980-2009

[4] Assa J., 2012, OECD, 'Financialization and its Consequences: the OECD Experience', VOL. 1, NO. 1, JANUARY 2012, New School for Social Research

[5] Stephany Griffith--Jones: The case for prudent financial liberalisation and its policy implications http://policydialogue.org/files/publications/Financial_sector_--_Berlin_Conference_Dec_2013.pdf
Stiglitz: Inequality is a choice http://opinionator.blogs.nytimes.com/2013/10/13/inequality--is--a--choice/?_php=true&_type=blogs&_r=0

The financial system is as big as before the crisis – and in fact bigger: **Eurozone bank assets have grown around 350% of GDP (2012)**, to be compared with 320% in 2008, and 230% in 2000.[6] In addition, the stock of private sector debt to GDP remains far above the levels recommended as optimal for growth.[7]

These trends are linked with poor demand and low investment. Reversing them **requires a strategy for reducing overall debt levels and reducing inequalities.**

Next crisis ahead of us

Excessive financialisation leads to burdensome levels of private debt. Already in the last financial crisis the high levels of private company and household debt proved devastating for citizens and the real economy alike. In its latest edition, the Geneva report on the World Economy "argues that the policy path to less volatile debt dynamics is a narrow one and that it is already clear that developed economies must expect prolonged low growth or another crisis along the way".[8]

Citizens and public finances remain unprotected

Despite significant regulatory efforts made to protect public finances from a future financial and banking crisis, when the next bubble bursts we will find ourselves in a situation similar to that of 2008 - with the adverse consequences we know. In particular, the Banking Union does not put an end to the "Too big to fail" problem.[9]

Indeed, the European banking system is still dominated by "too big to fail" universal banks - mega-banks that combine traditional banking activities (deposit, credit, payments) with investment banking activities (market-related activities, including trading and market making). They are too big, too interconnected and too complex for the prudential and resolution tools (Banking Union) to be effective and credible.

Their size, interconnectedness and complexity result from their transaction-based, short term oriented business model, which has developed dramatically within a very short period of time: in 12 years, the size of the top 15 EU banks has tripled. Such a model requires holding large inventories of financial instruments on the asset side and reliance on wholesale funding provided by other financial institutions on the liabilities side. As a consequence, the

[6] ECB, Eurostat, CLSA Asia-Pacific Markets
[7] Arcand, J.-L., Berkes, E., and U. Panizza, 2012, 'Too much finance?', IMF Working Paper 12/161, available online at https://www.imf.org/external/pubs/ft/wp/2012/wp12161.pdf
[8] "Deleveraging? What Deleveraging? The 16th Geneva Report on the World Economy" http://www.cepr.org/sites/default/files/news/Geneva16.pdf
[9] See also Finance Watch note « Too-big-to-fail in the EU », September 2014

application of bail-in tools would result in a domino effect, which any supervisor would want to avoid – hence triggering public intervention.

The financial sector is by far not facing the real economy (finance-to-finance activities)

This is not just a stability issue. “Too big to fail” universal banks are incentivised in ways that do not align with the growth needs of the economy, as can be seen from their balance sheets. TBTF banks typically dedicate less than 30% of their balance sheet to lending and even less to business lending[10]. Despite the fact that the economy is lacking long term and sustainable funding, no regulatory proposal has yet been tabled with the aim to refocus mega-banks on their core mission: serving the real economy.

Looking at specific financial markets one can see that the amounts being traded are more than 10 times the size of what is needed to fund real economy needs (i.e. non-financial companies):

- The share of derivatives’ transactions facing a non-financial company amounts to 7%. The remaining 93% is finance-to-finance activity. (source: BIS)
- International trade, which directly needs foreign exchange markets (e.g. trades between EU and US requiring exchanging EUR against USD) only represent 4% of the foreign exchange market. (source: IMF)
- We observe similar proportions in the bond and other financial markets, for example, non-equity securities issued by non-financial firms account for less than 10% of non-equity securities issued (source: ECB)

2. Finance that serves society

Society needs to be protected from financial crises

The facts listed above highlight the need for the EU2020 agenda to explicitly include financial reform objectives in order to have a realistic chance of delivering targets for smart, inclusive and sustainable growth.

The impact of the 2008 financial crisis « is both immediate and longer-term: it has already cost Europe a loss in wealth, and it has also eroded its potential for future growth as jobs, firms and "know-how" has been lost. »[11] A recent report from UNICEF[12] shows how “the

[10] See Finance Watch policy brief “Structural reform to refocus banks on the real economy”, July 2014
[11] EC communication on EU2020, March 2014
[12] http://www.unicef-irc.org/publications/pdf/rc12-eng-web.pdf

Great Recession is about to trap a generation of educated and capable youth in a limbo of unmet expectations and lasting vulnerability.” It adds that “in some cases, the honest efforts of governments have been hindered by the weight of the conditions imposed on them by the financial markets and the providers of financial assistance.” Many other reports have demonstrated the disastrous impact of the crisis on citizens, on European competitiveness, on poverty rates, on the condition of women in the EU, on child poverty in EU countries, and so on.

If anything, the EU agenda for smart, sustainable and inclusive growth needs to take stock of the damage done by the financial crisis and **make sure that progress made will not be damaged by the next crisis**. Building a resilient financial system should therefore be central to the EU growth agenda.

The role of financial regulation in reaching out to EU2020 objectives

Much has been done to regulate individual institutions: the European institutions as well as national policy makers and supervisors made substantial efforts to improve the regulatory framework in which the European financial institutions operate. This led to some progress; in particular one can point to increases in loss absorbency capacity at individual banks (improving their ability to absorb losses when they occur), improvements in the structure of capital markets, in investment product regulations and information to customers.

However, the situation described above shows that the regulatory framework is still far from complete: a lot remains to be done to improve the resilience and efficiency of the financial system

On top of the improvements that are still needed at the level of individual institutions, systemic risks still need to be addressed. Macro-prudential regulation needs to be developed with a view to addressing the high level of interconnection in the system and the risk posed by too-big-to-fail institutions. Tackling these issues will in turn help to refocus financial markets and banks on their core mission of financing the real economy and being at the service of society.

Several measures have already been identified and tabled, including binding rules on bank leverage, bank structure, implementing the Banking Union, rules on total loss absorbing capital and shadow banking. Others are being contemplated and promoted. Below are some preliminary remarks (which will be subject to further development in a forthcoming paper by Finance Watch) on two of them which are of particular relevance to the EU2020 agenda:

> *About the Long Term Financing (LTF) agenda of the European Commission*: The LTF agenda aims at complementing initiatives such as Europe 2020 by proposing means to finance related objectives and more specifically by suggesting channels to improve on the access to financing of infrastructure and SMEs. However, some

of the financing channels that the Commission is putting forward create some concerns, especially in terms of the systemic risks they embed, and might therefore get us away from the objective.

About Public Private Partnership (PPP): In a context of strained public finances and high levels of indebtedness in some member states, PPPs are being promoted as the best way to increase investment in infrastructure. However, PPPs must be considered with great caution as there is evidence that they are not always less costly for citizens and that historically they have a mixed track record with multiple examples of inflated costs, mismanagement, poor value for money for taxpayers and failure. At the very least, more transparency is needed in order to ensure a fair sharing of risks and returns, value for money for taxpayers and democratic accountability.

Society needs a financial sector that serves its purpose.

We suggest below a short list of features that one would expect in a financial sector at the service of society. These features need to be associated with adequate indicators for proper monitoring (see recommendations below).

1. The financial system should not be harmful to the economy and to society. This means in particular that in the occurrence of a crisis, private financial institutions should bear their full losses. It also means that the financial system should not act as a drain on economic resources; that it should be less prone to the formation and bursting of bubbles; and by reducing bank interconnection that the whole system should not be threatened by the failure of one individual institution.

2. The financial system should be diverse (in its activities, forms, ownership and business models, etc…) and competitive, which requires removing the subsidies that currently distort competition and limit the diversity of institutions operating in the system. A diverse and dynamic banking sector would be more resilient to shocks and more responsive to the needs of businesses and communities.

3. The financial system should face the real economy, which means that capital markets and banks should primarily focus on funding the needs of non-financial companies and support projects of importance for society at large. It includes, among other things, a more economically productive allocation of credit and capital, more emphasis on proximity and trust (e.g. through relationship banking), and shorter and less costly chains of financial intermediation.

4. The financial system should be sensitive to other policy areas, including environmental and social policies. This means embracing initiatives such as socially responsible investing, green bonds, social inclusivity and carbon risk, among many others. It also means not allowing green and social agendas to be exploited for financial lobby purposes, for example through the misleading argument that lowering capital standards for banks might increase green lending, or by promoting forms of green financing that are unnecessarily risky and expensive.

3. Recommendations for the EU 2020 strategy

We offer some suggestions to help financial policy support the goals of the Europe 2020 strategy. These suggestions aim to:

- Incorporate the completion of the EU's core financial reform agenda into the Europe 2020 goals
- Develop a positive vision for a financial sector that serves society and that identifies and encourages the types of financial institution and activity that would support Europe 2020 goals.
- Ensure the coherence of financial policy with energy, social and other policy areas.

Measuring the ability of the financial sector (and financial regulation) to deliver on societal objectives

EU institutions and EU citizens would benefit from a tool to measure progress made in the field of financial regulation against societal and economic objectives.

Finance Watch and its members have started to reflect on the creation of a Citizens' Dashboard of financial reform, that would measure progress against a set of societal objectives**. These objectives would be defined by citizen's / stakeholders expressing what they expect from the financial sector.** As an illustration, they could include measurable objectives such as reducing measures of financialisation, bank interconnectedness, system leverage, implicit funding subsidies and the cost of financial intermediation, and improving credit allocation, relationship lending, and the development of suitable new funding sources.

Among other things, such a tool would allow stakeholders to align their efforts and could be especially useful in the context of the EU 2020 agenda, as many civil society organisations support the sustainable and inclusive qualities of growth.

Flagship initiative "Finance for Society"

Given its central function in our society, finance is instrumental in the realisation of economic and societal objectives. It should be subject to specific follow-up and specific indicators, which can be used in the context of the EU2020 and the European Semester. It should on the other hand not be separated from other policy fields.

To date, finance is not included in the EU 2020 objectives. It is taken as a given that the system can support the objectives of the EU, or at least that it will not damage them given the regulatory work that has been performed over the past years.

Including finance in the Europe 2020 strategy would make it possible to track progress made, measuring how harmful the financial sector is, or could be, to society and the EU2020 objectives, and how far it is supporting the real economy and the EU2020 objectives. The tracking of that progress could become part of the European Semester and Country-Specific Recommendations, alongside other flagship initiatives.