Finance Watch
Making finance serve society

"The Weakest Link"

Speech by Frédéric Hache, Head of Policy Analysis at Finance Watch, at the Finance Watch conference *"Confidence, ethics, and incentives in the financial sector"*

Tuesday 17 November 2015, Hotel Leopold, Brussels

1. When I was working on a trading floor, ethics was one of those words like transparency or disclosure that **made compliance officers happy but didn't mean much** in practice. Why? It was **not only the cynical view** that you can't force them to be more ethical, hence it's irrelevant. It was also that, **since ethics was not linked to how my performance was measured and my bonus calculated**, why should I care?

Now that I have left investment banking, I still believe that **people's ordinary schizophrenia**, i.e. the ability to be very caring with their close circle of friends and family while sometimes being careless to others **will always lead to improper behaviour from time to time**.

I am convinced however that **people respond to incentives** and that we can create an environment **more conducive to appropriate behaviours**.

So when talking about ethics, incentives and behaviour in the financial sector, **what are we talking about, what are we trying to achieve?**

Ethics asks the question "what actions are right or wrong in particular circumstances." Essentially it asks the question **what actions and behaviours should be fostered and which should not be encouraged.**

This is particularly important in the case of financial services, **as even though the behaviour of financial services professionals is arguably no less ethical** than in other sectors, **the detrimental impact of undesirable behaviour is larger** in finance, given its central role in our economy and the cost of systemic crises for all citizens.

While it is still work in progress, **tremendous work has already been done in this area, to identify the appropriate behaviours and what we are aiming at.**

2. There is for example a fairly wide consensus around the idea that we should **encourage actions and behaviours that lead to finance serving the real economy and the widest range of stakeholders in a sustainable manner, rather than those where finance serves itself** and has a detrimental impact on the wider economy and society.

Practically this objective can include several intermediary goals, such as:
a. **A financial sector that is robust and stable**, that is able to provide essential services such as safety of customer deposits, payment systems and loans to businesses and households **without risking major disruptions with spill over effects** on other sectors.

This implies for example structuring our financial system so that financial entities are **not too interconnected and do not fail all at the same time**, so that they can be allowed to fail as in any other sector without triggering a domino effect or needing to be rescued.

b. **Another goal would be a financial sector that does not generate negative externalities or moral hazard**:

Linked to the previous point, the **impact of failures** and bankruptcies in the financial sector **should be borne by the financial sector, not external stakeholders**.

Negative externalities are an implicit subsidy from the rest of the economy to the financial sector and should be curbed as much as possible. Note that this subsidy is not value creation by the financial sector, but, rather capture from value created by other productive sectors. And if any external intervention is deemed necessary, it should be conducted at arm's length, with the external actors being fairly rewarded for the service they provide.

c. **We should also promote a financial sector that is able and willing to provide stable long term lending to key sectors of the economy where it's needed**.

Not one that overheats, is aching to lend ever more in good times - creating asset price bubbles in the process - and that **turns off suddenly the credit tap** in times of stress.

While there are many discussions currently about increasing the supply of credit to the economy these days, the **qualitative element is missing from the debate**: there is indeed never any shortage of credit in good times, the issue is when the funding channels dry up very quickly during crises. Therefore what may be needed is not more funding in general, but more stable funding that doesn't withdraw quickly in times of stress.

I also mentioned "willing" earlier: There have been many examples over the past years of **financial entities able to lend but not willing to**, as they chose to allocate their capital to more profitable activities. ECB's Long Term Refinancing Operation as an example did not generate additional lending to businesses. This could and should be addressed but has yet to be done.

Similarly some **key sectors might be underinvested as they are not perceived as attractive enough from a short term return** perspective whereas they are crucial for society as a whole and in a longer term perspective, such as financing the shift to a green economy.

d. **A financial sector that benefits the widest range of stakeholders as opposed to serving a minority**.

Searching for profitability is a legitimate objective as long as it doesn't involve predatory behaviour where asymmetry of knowledge and information is used to prey on the weaker stakeholders.

There have been numerous examples of it over the past decades from toxic structured loans sold to municipalities, to selling overly complex credit derivatives to uninformed investors etc.

Arguably the financial sector, just like any other private sector, is **making decisions that maximise value creation for its stockholders.**

Yet the creation of public safety nets a century ago and the recent bank bail outs have **implicitly recognised that some financial services are deemed essential** for the functioning of our economy. Therefore being subject to special scrutiny and regulation that aims to align the interests of bank employees with those of banks' wider stakeholders is thus **only a fair price to pay to enjoy this enormous benefit**.

In this respect, the recent resurfacing of competitiveness as the overarching objective of policy initiatives is a cause for concern. While this is a legitimate objective we should be **careful not to go back to a short-sighted focus on competitiveness at all costs**, including at the cost of financial stability **at a time where we haven't finished paying for the last crisis**.

My purpose here was **not to provide an exhaustive list nor close the debate**, but rather to **highlight the fact that while this is still work in progress, a lot of work has already been done** and there is a wide consensus around some objectives and behaviour that we need to promote.

3. Now how do we translate objectives into change, how do we get there? What incentives are necessary?

Here too I would argue that **while this is still work in progress, tremendous work has been done** before and after the crisis to identify the best incentives and rules to foster the most suitable behaviours and models.

And the good news is that while financial entities and **markets evolve quickly**, **detrimental behaviours and majors factors of systemic risk do not**.

As an example, the near collapse and bailout of **Long Term Capital Management** the biggest hedge fund of the world in 1998 was **already a lesson about excessive leverage, and interconnectedness through derivatives**, the same factors that were present in the 2007-8 crisis.

So we know pretty well **which bank business models are more robust and more focused on lending** to the real economy and which are not.

We also have a fairly good understanding of **which compensation structures align interests with clients and stakeholders at large** and which create conflicts of interests.

We know as well **which financial channels are more stable, less prone to overheating and less likely to create domino effects**.

We have learned as well that tools such as **financial education, transparency and disclosure, while useful are not sufficient and need to be complemented** by financial incentives and/or binding regulation in some areas.

Some of these incentives have been translated into law and implemented, such as clawback clauses on bonuses aimed at aligning the compensation structures of traders with the risk that they take, or increasing bank regulatory capital.

Many of them have yet to be translated and implemented, such as a meaningful bank structure reform aimed at avoiding conflicts of interests, curbing moral hazard and reducing risks for taxpayers.

And **recent regulatory initiatives that put competitiveness before all of the previously mentioned objectives** might put us further away from achieving these objectives.

Finance Watch
Making finance serve society

4. **Which brings me to my last point: could it be that the weak link in achieving change is not so much knowing where to go or what to do, but rather a lack of political will to reform?**

A **number of objectives have already reached a wide consensus**, such as financial stability, accountability, inclusiveness, addressing conflicts of interest and **a number of tools have been identified** to achieve these objectives. So **what is missing to translate these into law and implement them?**

Put differently, what explains that **8 years after the most severe crisis for 80 years and after 5 years of financial reform**, we have not managed to **comprehensively integrate the lessons from the crisis**, whereas the **political momentum for financial reform is closing** and we are **going back almost to business as usual and to the failed mantra of deregulation for growth**?

So the question is, **how do we reopen the political momentum for reform, and more generally how do we ensure that a limited amount of political will can translate into doing the necessary reforms without waiting for the next crisis**?

Arguably policy makers have to **juggle with many objectives that can sometimes conflict**, from financial stability to financial inclusion to job creation and competitiveness.

Yet I strongly believe that **taking the long term view over the short term one already removes a large number of these perceived conflicts**: as an example while financial stability might conflict with a search for additional short term profitability of financial entities, it does not conflict with sustainable value creation.

I also believe **that in case of doubt or conflict, the guiding and overarching goal should always be public interest, understood as measures that benefit the most over measures who benefit a minority**. The **current economic context of low growth, low interest rates and fears of deflation** puts policy makers under **additional pressure to focus on short term solutions** rather than long term ones.

Other factors sometimes compound these issues such as the **short term mandates of politicians**, **intellectual capture and belief in failed dogmas** like austerity policies, **lack of resources to analyse in depth the issues**, and **allowance for revolving doors** and exposure to **highly unbalanced lobbying**. Last but not least, the fact that elected officials are not legally bound by their electoral promises, which is a concept stronger than accountability, is another impediment for the public interest.

All of these factors and others might **incentivise policy makers to take an excessively short term view.** They might also in some cases **misalign their personal interest and public interest**, and **weaken the political will to put in place necessary reforms**.

To be clear, I **do not claim to have the answer** to these issues. But the question I want to leave you with today is this one: **when we talk about ethics, behaviours and incentives, shouldn't we take a broader view and not only focus on incentives for the financial sector but also on incentives for policy makers to take the long term inclusive view if we want to be able to achieve change**?