EXECUTIVE BRIEFING

Benoît Lallemand, acting secretary general of Brussels-based Finance Watch, briefs *Insights* on how finance can best serve society while still doing good business

By Fin Keegan

Please outline the mission and activities of Finance Watch.

Our mission is to advocate public interest outcomes in financial regulation. We act therefore as a counterweight to the private interest lobbying of the financial industry by strengthening the voice of society in the reform of financial regulation. Our vision is for a financial system that allocates capital to productive use through fair and open markets in a transparent and sustainable manner, without causing detriment to society at large.

Who are we? Finance Watch is a network of around 75 civil society organisations and individuals, supported by a secretariat of 12. The members of our network campaign together – for example, through organising conferences and coordinating lobby campaigns – while the secretariat supports that effort by carrying out policy analysis and then lobbying and communicating our positions to policymakers and the public.

Your organisation's motto is "making finance serve society". Should this be the motto of the retail banking industry also?

Absolutely. Retail banking is an essential public service and should be carried out in a way that serves society. There is an in-built tension between the public utility aspect and the private profit element in banking so having the aim, or even the obligation in some cases, to meet society's needs first would be an excellent way of managing that tension. Several economies have benefited from public banks, for example Brazil's BNDES or the Bank of North Dakota in the United States, or Germany's network of Landesbanken and Sparkassen. It's a question of getting the right mix and diversity of banking business models.

You want to build a resilient banking system that serves society and is not founded on moral hazard. With Banking Union on the agenda, what are the challenges in this respect for the retail banking sector?

In theory, the Banking Union's bail-in regime should increase market discipline in the way banks' wholesale liabilities are priced (ie, by making them price-in the banks' risk). This should reduce moral hazard and improve the quality of risk-taking and lending as risk and reward are reunited. It should also favour banks with a higher level of deposit funding, which ought to help financial stability, improve bank diversity (by reducing large incumbent subsidies) and improve lending in the real economy. In practice, however, many retail banks in the EU are locked into universal megabank structures with highly interconnected business models. Unless those structures change, bail-in might not be feasible as regulators will not risk triggering a domino run of bank failures. The way that bank structures evolve in the years ahead will be critical in determining whether Banking Union delivers its hoped-for benefits. Without structural reform to TBTF banks, Banking Union could actually make things worse by federalising risk among eurozone members, thus increasing the safety net and moral hazard. That is why Finance Watch has been pushing hard for bank structure reforms to be part of the Banking Union initiative. I also feel bound to point out that bank structure reform in the EU would reduce the funding differences between UK banks subject to ring-fencing and EU banks, a state of affairs that should benefit both the single market and UK banks.

How do you regulate the financial sector effectively? To what extent should self-regulation be involved?

We need regulation; the experiment with financial liberalisation has, self-evidently, been a failure. A market without rules is not 'free' in any positive sense, it is simply prone to disorder and exploitation. The question is what sort of regulation produces good markets in finance. Self-regulation can work in certain circumstances – for example in the old members' stock exchanges, where there was enough proximity and market discipline to keep individual and collective interests aligned – but even then the collective interest of market participants might not be the same as the public interest. Markets will want to regulate themselves in the way that best suits their participants, and finance has become so complex and remunerative with so many information asymmetries and conflicts of interest that it is no longer realistic to hope for self-regulation, as the benchmark scandals remind us.

The second thing is for regulation to be strong and simple. As the BoE's Andy Haldane said [in his 2012 speech "The Dog and the Frisbee"], you do not fight complexity with complexity. Rules that are easy to define and enforce are more effective and impose a lighter compliance load on participants than complex rules with a thousand loopholes. This is where I feel that the financial lobby has shot itself in the foot: its automatic response is often to resist simple, clear reforms such as hard leverage caps or structural separation and force regulators into complexity.

The result is tens of thousands of financial sector employees tied up in unnecessary compliance work, while the financial sector – and society – remain exposed to the problems that regulation originally meant to solve. In the end this just means more regulatory initiatives in future. Finance Watch favours simple, strong, effective regulation designed with both the public interest and the economic purpose of the market in mind.

Restoring ethical behaviour to the banking sector has become a priority for responsible bankers and industry stakeholders. What is your view of the steps taken so far?

We share the banking industry's concern about its reputation: it is essential for people to have trust if banks are to serve society's needs. The industry's own response has been based around codes of conduct, which have good symbolic power but limited ability to change the hard incentives that underpin unethical behaviour. Benchmark manipulation illustrates the problem: if traders at some banks are front-running their clients to make large profits for themselves, as has been alleged in a number of investigations and lawsuits, how large do bonuses have to be before a code of conduct ceases to be a deterrent – ten thousand, half a million, two million?

At some point the incentives become overwhelming for traders and managers alike. A system that does not recognise human fragility is itself fragile. We think that codes of conduct should be a secondary measure, with structural reforms to address and, where possible, eliminate conflicts of interest as the primary measure.

How important is it that new people entering retail banking are educated in the ethics of the profession?

At Finance Watch we would always be keen to make sure that there's a link between this sort of teaching about culture and ethics and the 'real worlds' of the profession, the environment and regulation. I'd make sure that you start now by making sure that you have the proper education and probably industry standards (in terms of behaviour, accountability, responsibility and so on) matched by an understanding of the history of the crisis and what you want to avoid in the future.

This would make it stronger, because it's not just about "Okay, I'm getting a job and I need to comply with this and that and this is how I should behave" but making it a lesson learned, a process where you look at what can go wrong if you don't follow the rules and principles. It is important not just for the intellectual purpose of studying history.

My point is that then these ethical principles or this education does not just come out of the blue, as some nice thing to have, but also as part of the safeguards against something pretty traumatic for society that happened in 07-08.

There has been a lot of action taken on both sides of the Atlantic to restore the socially productive dimension of banking. Do you feel a genuine sea change is in progress in banking?

There is a difference between what regulators have been trying to do and whatever cultural change there might have been in the industry. I am not sure these processes are always aligned. Obviously both are extremely useful. After the crisis, the G20 was focused much more on stability and prudential regulation, making sure that finance would not hurt society again: a sort of negative agenda. Only now are we coming to the question of "making finance serve society".

This is important because, I'm afraid, we are still in a paradigm where it's all up to the financial markets to decide what is good or not.

The assumption for the last 20 years was something like "Open the Pandora's Box of financial innovation and creativity and amazing goods will automatically result for the rest of the economy". That was wrong because of the lack of a safety net or lack of capital or too much leverage, yes, but it's also deeper than that.

You were formed out of a sense that there was an "imbalance in lobbying": what is the situation now?

In Brussels, the imbalance is as strong as ever: the financial industry spends at least 30 times as much as civil society does on lobbying. Civil society networks find it very difficult to participate in technical consultations, often to short deadlines, and to participate effectively in stakeholder groups dominated by financial sector representatives with more resources to prepare.

Policymakers are aware of this and try to make allowances, but there is a limit to what they can do in the face of a 'lobby tsunami', especially when political and regulatory capture are included. Cognitive capture also plays a role: the assumptions on which policy is made are often biased in favour of the financial sector.

For example, until recently it was common to say that more finance always benefits the economy, but evidence in recent years shows that this is only true up to a point (which the EU passed a while ago!) and after that financialisation acts as a drag on economic growth.

Similar misconceptions exist in relation to market liquidity and risk transfer, but it is hard for policymakers to take a considered view if 95 percent of the lobbying they hear takes these assumptions for granted.

Benoît Lallemand is acting secretary general and co-head of Policy Analysis of Finance Watch in Brussels, online at www.finance-watch.org