Opinion of the European Economic and Social Committee on 'After the crisis: a new financial system for the internal market' (own-initiative opinion)

(2011/C 48/08)

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On 18 February 2010 the European Economic and Social Committee, acting under Rule 29(2) of its Rules of Procedure, decided to draw up an own-initiative opinion on:

'*After the crisis: a new financial system for the internal market*'.

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 8 July 2010.

At its 465th plenary session, held on 15 and 16 September 2010 (meeting of 16 September), the European Economic and Social Committee adopted the following opinion by 160 votes to eight with two abstentions.

1. **Conclusions and recommendations**

1.1 With this own-initiative opinion the Committee aims to set out possible reforms to Europe's financial system in terms of how it should be regulated and how to enhance the way it operates so as to reduce systemic risks. The financial crisis could yet flare up again with renewed vigour and intensity if rampant speculation remains unchecked and governments fail to provide the long overdue responses.

1.2 **After the crisis, what kind of financial system is needed for the internal market?** The ECB/ESCB, commercial and investment banks, mutual and cooperative financial institutions and ethical banks, insurance companies, pension funds, investment funds, private equity funds, hedge funds, rating agencies; creators, distributors and vendors of financial products and securities; stock exchanges, unregulated markets; regulators, supervisory authorities and credit rating agencies: these are the key players in the financial system that will be called on to modify their behaviour, adjust to more stringent rules, and adapt their organisations to the new tasks that will be assigned to them.

1.3 **Not all market players should be tarred with the same brush.** Fortunately, some important sectors such as certain major cross-border groups were not directly involved in the crisis, as their activities were far removed from the financial casino. Insurance companies, cooperative, popular and savings banks, as well as leading European and global commercial banks have not had to make financial adjustments because of losses incurred, or seek government help.

1.4 **'This crisis has been caused by moral poverty' – the Committee would echo this assessment made by Tomáš Bat'a in 1932, while pointing out, regrettably, that nothing has changed!** It is very much in the interests of workers and pensioners, companies, the general public, civil society organisations, consumers and users to be able to count on an efficient, secure and affordable financial system, to which they can entrust their savings with confidence, seek backing for economic initiatives, and look on as a vital instrument of economic growth fulfilling important social functions such as pensions, health, accident and damages insurance. The grave financial crisis has put all of this in jeopardy, through a widespread loss of confidence.

1.5 **Confidence needs to be rebuilt not only in financial institutions but also in the political institutions, regulatory and supervisory authorities** that failed to avert this disaster which has so far cost EUR 2.3 trillion, according to the latest IMF estimates.

1.6 **Huge public disquiet has been generated**. The liquidity crisis stemming from the financial crisis has had major repercussions on the real economy: unemployment has broken the 10 % mark, reaching 22 % in Latvia and 19 % in Spain, with the number of unemployed people exceeding 23 million in December. This figure is set to rise further. All countries have recorded huge budget deficits, which will have to be redressed with corrective measures; this will certainly not help growth, but rather curb an already sluggish recovery, i.e. one without positive effects on unemployment.

1.7 Over the past few years, the Committee has issued a series of opinions setting out a number of proposals, which were often ignored. Had they been heeded, these proposals would undoubtedly have helped avert or at least mitigate the devastating effects of the crisis.

1.8 **The Committee calls on the EU institutions to speed up the reform process**. A year and a half since the publication of the de Larosière recommendations, the EU decision-making process is not yet in its final stages. Unfortunately, governments have watered down the reform plan, ruling out, for example, the possibility of intervention by a European authority on cross-border financial institutions.

1.8.1 **The Committee welcomes the Commission's Communication on legislative initiatives to** bolster financial market regulation and transparency. These proposals, which emerged while this opinion was being drafted, are a step in the right direction. Improving supervision of credit rating agencies and launching a debate on corporate governance are the most important aspects. Reports on directors' pay and remuneration policies complement the package of proposals. The Commission has committed itself to tabling further proposals within the next six to nine months, including initiatives to improve the functioning of derivatives markets, appropriate measures on short selling and credit default swaps, and improvements on the Markets in Financial Instruments Directive (MiFID).

1.8.2 **The Committee awaits with great interest the other initiatives announced** under the heading of *responsibility*, including the revision of the Deposit Guarantee Schemes Directive and the Investor Compensation Schemes Directive. The Market Abuse Directive and the Capital Requirements Directive (CRD IV) are to be amended, while a new proposal on packaged retail investment products (PRIP) is in the pipeline. To reduce regulatory arbitrage, the Commission intends to publish a communication on sanctions in the financial services sector.

1.9 **The Committee believes that work should be stepped up on shaping the post-crisis financial system**, which should be transparent, socially and ethically responsible, better supervised, and innovative; its growth should be balanced, compatible with the rest of the economic system, geared towards generating medium- and long-term value and sustainable growth.

1.10 **Several million people work in the world of finance. The vast majority are upstanding, professional people who deserve respect.** A small minority of irresponsible, unscrupulous people have jeopardised the reputation of a whole category of workers.

1.11 **The Committee recommends greater transparency, particularly in identifying risks.** OTC markets should not be open to bilateral transactions, but limited to central counterparty transactions, which by monitoring the overall level of risk can limit access to transactions for over-exposed parties. Such transactions should take place either on a single platform, or at least on a defined set of platforms, in order to increase market transparency.

1.12 **Corporate social responsibility** should permeate all activities and modi operandi in the financial sector. **Sales volumes have taken precedence over proper investment advice.** A high level of professional ethics ought to be restored, and there should be explicit condemnation by the sector's associations, who should encourage proper conduct by taking preventative measures and impose penalties on businesses found guilty of acting in bad faith, of commercial fraud or of other acts falling under criminal law.

1.13 **There should be more open and democratic governance of national and EU authorities, involving stakeholders in regulation and supervision**. Workers, companies, consumers and users should have a recognised role in corporate governance. The Committee advocates greater involvement of civil society in consultations and impact assessments. Recent Commission decisions on selecting expert groups have again focused solely on industry, without properly involving consumers and workers. The Committee will tirelessly continue to press for balanced representation of civil society within expert groups and committees set up by the Commission.

1.14 Corporate governance whereby requirements in terms of integrity and transparency extend from directors through to shareholders; the origin of their capital has up to now automatically been assumed to be lawful, while controversial cases have shown that this is not always the case.

1.15 **Managers have come to play an excessive role, often receiving astronomical remuneration** which has remained intact even after their institutions have been bailed out through nationalisation. A serious policy on curbing bonuses, which should perhaps be awarded only where consistent above-average results are achieved in the medium term; staff incentives should be linked to responsible sales and not to banking-product campaigns without due respect to consumers' needs; the incentives should upgrade the quality of human capital in terms of professional contribution, client satisfaction and greater professionalism.

1.16 **The Committee recommends that serious and effective measures be adopted by national supervisory authorities**, which seem fairly unconvinced of the case for taking action not only to raise ethical standards, but also aimed at preserving for the future the risk profile, both overt and hidden. Many very high-risk profit- and bonus-driven operations could have been avoided.

1.17 **The Committee calls for the removal from European legislation of references to ratings in respect of classifying investments and their coverage in risk funds**, in line with the Basel II principles, and calls on national authorities to revise investment policy.

1.18 **The rating of Member State sovereign debt should be carried out exclusively by a new independent European agency**. Announcements of sovereign debt downgrading – as recently happened in Greece and other EU countries in difficulty – have triggered serious market upheaval and massive speculation, thus increasing the perception of a serious crisis.

1.19 **The aid granted to Greece will help safeguard the international financial system** which has guaranteed Greece's debt to the tune of hundreds of billions of euro, and placed its trust in the world's largest commercial bank, which concealed major borrowings so that they did not show up in Greece's public accounts. The French and German banks alone (EUR 76.45 billion and EUR 38.57 billion respectively) account for loans of EUR 115 billion: once again the European taxpayer will be called on to pay for the unlawful actions. The Greek people will have to shoulder a huge economic and social cost.

1.20 **The Committee thinks it worth discussing the taxation of certain financial activities**, particularly those that are predominately speculative. It has recently adopted an opinion on this issue.

1.21 **The Committee advocates developing integrated crisis management systems, including effective criteria for early warning, prevention and exiting the crisis.** Reliable mutual accountability mechanisms need to be developed between Member State authorities, especially with regard to the major European groups: in central and Eastern Europe, for example, the financial markets are almost exclusively in the hands of Western insurance companies and banks.

2. Introduction

2.1 *'This crisis has been caused by moral poverty.*

A turnabout in an economic crisis? I believe in no spontaneous turnabouts. What we are used to calling the economic crisis is just another name for ethical poverty.

Moral poverty is the cause and economic decline is the effect. In our country, many people think that economic decline can be remedied with money. I dread the consequences of this misconception. In our current situation, we do not need any ingenious turns or schemes.

We need a moral approach to people, work and public property.

No more support for bankrupts, no more debt, no more throwing values away for nothing, no more extortion of the workforce; we had better do the things that helped us rise from post-war poverty: work and save, and make working and saving more profitable, desirable and honourable than slacking and squandering. You are right; the crisis of trust needs to be overcome - but it cannot be overcome with technical, financial or credit interventions. Trust is a personal matter and can be regained only through a moral approach and personal example'. Tomáš Bat'a, 1932.

2.2 *Nothing has changed.*

2.2.1 This quotation, unusual in a Committee opinion, serves as an introduction to the subject which is more than just another learned analysis of the crisis, of mistakes made by political and supervisory entities, rating agencies and the financial sector, and by investors and shareholders. Rivers of ink have flowed, but the message could be summed up as: the measures taken, under consideration or planned, regarding macro- and micro-prudential oversight are fundamentally both valid and rational, but still lack a comprehensive, structural element binding market surveillance (covering banks, insurance companies and the financial markets) and supervision of payment systems. These systems can provide valuable warning signals – provided they are properly interpreted – of individual failings or systemic threats. The authorities should envisage adopting a cross-checking system of this kind.

2.2.2 Unlike in the past, civil society has no intention of leaving the debate on the future of the financial system to the specialists, experts and politicians, but intends to take an active part in building a sustainable financial system, because the consequences of the choices made will inevitably impact upon workers, businesses and citizens in general. The public funds that have been spent firstly on saving the most exposed banks, and then on breathing much-needed oxygen into an economy suffocating under an unprecedented liquidity crisis, have served to increase public deficit and debt. These will have to be balanced via further corrective measures, again by piling taxes and duties on the public – the last thing it needs.

2.2.3 The post-crisis financial system must not and cannot be the same as the one that emerged over the last 20 years. Growth rates that rocketed as a result of short-termism must be a thing of the past.

2.2.4 Profitability was so high that it spurred the most eager companies to embark on a wave of mergers on a scale that only a few years ago would have been unimaginable.

2.2.5 These mergers were facilitated by liberalisation, and in many countries by privatisation, but above all by the impetus given by the single market directives, which broke down not only territorial borders, but also the dividing lines between different specialist categories: commercial banks, investment banks, finance houses, stock brokering companies, securities depositaries, payment systems managers, insurance, etc.

2.2.6 The financial conglomerates thus created are marked by their highly varied nature, the complexity of their structures, their cross holdings and golden shares (for former public banks in particular), making overall surveillance of these structures extremely difficult, if not impossible. Only now, in the wake of the storm that has swept through the markets, has the need for cross-border forms of surveillance been understood. Decision-making processes, however, are too slow. Powerful financial organisations are seeking to limit regulatory action by the authorities, and have succeeded in convincing certain European governments to support their stance. The La Rosière report, the ensuing directives, the revision of the Basel II agreements and the IASB review are struggling to make headway and many promises of change seem to be falling by the wayside.

2.3 *Profitability*

2.3.1 Profitability and growth

2.3.1.1 High profitability has always been seen as a sign of good company health. It is also a factor for expansion by reinvesting profits. If a company with 10 % ROE ploughs back all its profits, it can grow by 10 % a year, provided it keeps to a constant ratio of debts to own resources: if it grows faster, the weight of debt will increase, or it will have to draw further on its equity capital.

2.3.1.2 In consequence, more profitable companies have more opportunities for growth and development.

2.3.2 Profitability and risk

2.3.2.1 Greater risks must often be accepted in order to boost profitability: it is argued in this regard that what counts is risk-adjusted profitability. Only an increase in risk-adjusted profitability represents real generation of new value (for shareholders, that is, not necessarily other stakeholders).

2.3.2.2 Who decides what level of profitability is appropriate to the risk? The financial market, of course.

2.3.2.3 What lessons can be drawn from the crisis in this regard? The answer is that while the ability to interpret and estimate many risks has improved, the market is not always capable of quantifying them accurately.

2.3.2.4 It follows that certain profitability and growth models, for both individual companies and the economy as a whole, took on a convincing appearance for the simple reason that they were estimating the risks inaccurately.

2.3.2.5 The key lesson of the crisis is that we will never be able to estimate all risks accurately.

2.3.3 Profitability drivers

2.3.3.1 The two main drivers of profitability, and not only for financial companies, are:

— efficiency improvements, made possible by economies of scale (expansion in size) and economies of scope (expansion of the range of products and services);

— innovation: offering new goods and services with greater profit margins due to less competition.

2.3.3.2 For these reasons, ‘big is beautiful’ and ‘financial innovation is good’ were the long-standing mottoes of many actors on the financial markets. The fact is that the risks associated with these factors were underestimated. To recap:

2.3.3.3 Size – economies of scale: the main risk is the systemic risk of ‘too big to fail’.

2.3.3.4 Variety of supply – economies of scope: the main risk is always of a systemic nature, but could be summarised as: ‘too interconnected to fail’.

2.3.3.5 Financial innovation: this means introducing new products/services to manage new risks or to manage known risks in new ways. If these had entailed everyday operations, someone else would already have done them. Estimations of the ensuing risks are often very vague.

2.4 Poor estimation of the risks of financial innovation lies at the origin of the financial crisis. At the same time, innovation is crucial to achieving high profitability – too high in the light of the growth rates of the developed economies. The cause of the crisis, rather than its effects, should be the main focus: we must accept profitability and growth rates lower than the double-digit figures that have been seen as not only a legitimate, but even a necessary, expectation. This is because it is by definition highly likely that very high profitability, in an economy that can no longer grow in the way it could 50 years ago, brings with it risks that cannot be ignored. Unless we say loud and clear that in a developed economy it is unreasonable, indeed insane, to expect double-figure returns on investment, we will continue to nourish the seeds of what led us to within a hair's breadth of system collapse.

2.5 *The business of banks and financial intermediaries*

The financial system acts as an intermediary between monetary and financial activities and risks. Risk intermediation takes place primarily in the form of derivative contracts, largely OTC derivatives. Monetary policy can directly influence monetary and financial intermediation, but is toothless where derivatives are concerned. Derivatives actually employ only very small amounts of liquidity.

2.6 *The derivatives risk: the risks of managing risks*

Derivatives have represented the main instrument for financial innovation. The OTC market provided an arena for risk sharing where the risks originally borne by a single player were transferred and broken down into innumerable transactions. In theory, this should produce fragmentation, and thus neutralise the original destabilising features of the risk. What was overlooked, however, was that the myriad interconnections involved in these transactions introduce an uncontrollable counterpart risk – so that effectively the overall risk is lost sight of – and lead to a 'too interconnected to fail' situation.

2.7 *A routemap to a more stable financial system*

It would be wrong to take a negative view of financial innovation, on the grounds that it helped to create the conditions for the crisis. But neither can what has happened be seen as a mere lapse: on the contrary, it shows that the system, as it stands, is unacceptable.

An integrated risk supervision structure must operate in three directions: instruments, market and institutions.

2.7.1 Instruments

Rather than banning the creation of new instruments, it would be better to apply a sort of registration mechanism establishing who they can be offered to. Unregistered instruments can be used only by qualified operators. The same principle as for medicines should be applied: some can be sold almost freely, others need a prescription and yet others can only be sold in specific settings.

2.7.2 Institutions

The conventional micro-prudential oversight that should monitor the stability of an intermediary is not enough. In order to create a macro-prudential framework, two major externalities need to be taken into account:

— interconnection. Financial institutions have common exposures that amplify the negative impact of risks, in other words, the previously-mentioned twin problems of 'too big to fail' and 'too interconnected to fail';

— pro-cyclicality. The financial system should manage the risks of the real system. In practice, it often happens that the dynamics of the one reinforce those of the other, the result being that the boom and bust effect is aggravated rather than being attenuated.

2.7.2.1 The 'shadow banking system' has served not only to pursue legitimate aims of greater flexibility, but also to sidestep prudential rules. Regulated parties, such as the banks, have used it for 'prudential arbitrage' purposes, i.e. to increase financial leverage despite the operational requirements of the rules. This system should be firmly embedded within the regulatory framework. Banks should not be able to use this system to avoid capital requirements.

2.7.3 Markets

The crisis has shown beyond any doubt that the financial markets have no independent capacity for self-correction through the creation of new conditions for balance, in all situations. The possibility of switching abruptly from abundant transactions to illiquidity is therefore a real one.

2.7.3.1 When transactions are bilateral, as with OTCs, the failure of one institution can rapidly infect many others, with the ensuing systemic risk. In order to limit systemic market risks, bilateral transactions must be replaced with central counterparty transactions: moreover, such transactions should take place either on a single platform, or on a defined set of platforms, in order to ensure greater transparency. It is likely that these conditions would entail greater standardisation of the traded contracts: far from an unwanted side-effect, this would be a positive outcome enhancing market transparency.

3. **Governance**

3.1 Markets may be hard to monitor: governance is even more so. Although supervision may in appearance be a matter for the majority holder – either directly or through agreements – in practice the different bodies of legislation, some more permissive than others, allow financial bodies of doubtful origin to flourish. In addition to the general issue of transparency, a complex matter is involved: the penetration of high finance by hidden powers or financial crime networks. This covers sovereign or state-controlled funds, laundering, tax evasion and tax havens; in other words, the presence – not necessarily predominant – of 'opaque' interests. The issue affects not only large groups but also – possibly to an even greater extent – a vast swathe of financial enterprises and investment funds, not necessarily operating on a large scale. The directives lay down rules on who can sit on boards and what shares may be traded on the stock markets, but have nothing to say about the nature and origin of capital, implicitly accepting that the origin is lawful. The aim is not to introduce new rules, but to establish operational links between the investigating authorities and the supervisory authorities.

3.2 The Achilles' heel of major groups is often precisely poor governance, which is shaped to suit managers, now the real masters of companies. Capital dilution due to the progressive integration of market players has gradually weakened the position of reference shareholders, sometimes to the point where they cannot withstand hostile takeover bids. Major international groups have been first acquired and then stripped by competitors, with very harmful repercussions for the real economy and for workers.

3.3 '… *The comparatively near future (…) will find society organised through a quite different set of major economic, social, and political institutions and exhibiting quite different major social beliefs or ideologies. Within the new social structure a different social group or class – the managers – will be the dominant or ruling class.*' (James Burnham, *The Managerial Revolution: What is Happening in the World*. New York: John Day Co., 1941)

3.4 The political authorities, in thrall to banking magnates, have gone along with this transformation. Even in the recent forced purchases of banks by some countries, they have proved incapable of restoring any degree of balance to the relationship between managers and shareholders. President Obama's resounding defeat at the hands of top AIG executives, who pocketed USD 165 million, taken straight out of the 170 billion provided by the US Treasury, gives some idea of the scale of the disproportionate, and in this case brazenly arrogant, power wielded by managers. In the United States, the banks have been able to pick themselves up thanks to a USD 787 billion stimulus package, paid for by tax-payers. They then showered bonuses on their managers (49.5 billion among Goldman Sachs, J.P. Morgan Chase and Morgan Stanley alone). And now, thanks to these miraculous bonuses, they are even making tax savings: since these payments are tax-deductible, the system as a whole will (according to a calculation made by Robert Willens LLC) save something like 80 billion. The figures in Europe are less spectacular, but RboS has handed out GBP 1.3 billion. Nothing has changed!

3.5 A serious rethink of governance mechanisms is needed, rebalancing company power between shareholders and managers, and putting each in their proper place.

3.6 Stakeholder participation in governance and more advanced economic democracy could help rebalance power and shift company strategies from short-termism to a long-term approach, with an obvious benefit for the whole economy.

3.7 The new financial system should be geared towards sustainable, stable profits, and a prudent approach to risk management and investment policy, after the carefree days of double-digit growth rates.

4. **Credit: a force for development and social function**

4.1 The irreplaceable role of the financial system in channelling resources towards productive activities has an obvious, and positive, social impact. Thanks to support from the banks, work and the wealth generated by businesses redistribute well-being and services to the community. Risk-sharing by insurers ensures that economic activity can take place in a stable, calm environment.

4.2 This social function must not, however, be confused with the 'social' risk assessment. Banks are businesses like any other, and must answer for the funds entrusted to them: a bank that finances a company heading for collapse is liable to prosecution, and where private individuals are involved, will be accused of pushing them into over-indebtedness.

4.3 The sole valid criterion for granting credit is a strict, objective and responsible assessment of risk together, of course, with an appreciation of the social purpose of the funds made available: there is a real difference in choosing between someone requesting funds to boost production or to avoid redundancies, and another who plans to move business abroad. These are universal values that are valid for all banks, large or small, limited liability companies, cooperatives or savings banks, as well as to those performing declared 'social' functions, such as microcredit, or ethical or socially-responsible credit.

5. Towards a post-crisis financial system

5.1 Tomáš Bat'a pointed to the right path almost 80 years ago: a determined return to professional ethics; a rediscovery of values and principles which had become seriously weakened over time; the acceptance by investors of less spectacular but more stable rates of return, as part of a long-term policy; the separation of purely speculative activity from other financial activities, and better regulation of the former.

5.2 A transparent financial system, providing enough information to make clear the risk involved in the proposed transactions: from revolving credit cards (some very large operators were recently banned from continuing to sell their products that infringed anti-usury and anti-laundering laws) and the most complex financial products, to the most straightforward.

5.3 A socially responsible financial system. The push for short-term profit has spurred many financial companies to privilege the quantity of sales volumes over the quality of customer service. Many people have been swayed by offers of financial products that have proved completely unsuited to savers' needs. These are proven instances of sales against advice, common sense and basic professional standards rather than following sound advice. In order to achieve better results, these sales have been pushed hard by constant and urgent commercial pressures, involving awards and bonuses – but also behaviour tantamount to bullying of those workers failing to secure the ever-higher results demanded of them. The principle established in law regarding commercial fraud and hidden defects should apply to the financial system too.

5.4 An ethically responsible financial system. The sector's associations should take initiatives to prevent misconduct and take on the responsibility of imposing exemplary penalties on businesses found guilty of acting in bad faith, of commercial fraud or of other acts falling under criminal law. No such position has yet been taken.

5.5 A better-regulated, better-supervised financial system. The number of actors within the financial system is expanding, while the ability of the supervisory authorities to track market developments, and of lawmakers to impose order and keep inappropriate players, if not criminal organisations, at bay shrinks. The sector needs to be rationalised, cleaned up and put in order. Although finance should follow the most advanced management models, it is not an industry quite like others. Its stock-in-trade is the trust of savers and clients, crucial to its business. Awarding AAA status to securities provided savers with a feeling of complete reassurance. The facts have demonstrated that the mechanisms put in place are very far from ensuring certainty.

5.6 An innovative financial system. The pursuit of new financial instruments, designed to better serve market needs, must continue to drive the economy. Reducing financial leverage, increasing risk-protection opportunities and settling for fair returns is the right way to move forward: a return to the future. After the two steps back represented by rash adventurism, we should take three steps forward towards a future of sustainable development.

Brussels, 16 September 2010.

The President
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