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Markets and Morals: Embedding values in the governance of the financial services sector

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Written by Oshani Perera

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Abstract

The power convergence between financial corporations and government and the regulatory reforms supervising this close relationship have been matter of discussion. The contribution of this paper is the focus on those elements that allow for better control of this relationship. Regulatory reform can only be successful if it influences the elite sources of power and responsibility within the financial system. The challenge is therefore to not only make rules that will bring about more systemic stability and render safer the global financial system, but also to make rules that will solicit the cooperation of these special interests in power. The financial system is indeed far too complex to be governed by narrow directives, and inputs from experienced insiders are critical. The end of financialization and the need of reinforcing fiduciary duty between and across all actors in the financial system are two possible ways to get the *high circles of finance on the right side of the law*. However, though there are technical restrictions for the implementation of the mentioned solutions, it is difficult to change the mindset and instill fundamental social values in these powerful (financial) sources. Therefore, societies may need to lower their dependence on the financial sector for the delivery of essential social services and environmental sustainability.

Introduction

The global financial crisis is the result—among others—of a deregulation that, over the last two decades, counterintuitively contributed to the convergence of power of big financial corporations and that of the government. This power convergence gave rise to a financial institutional influence and lobbying activity that was often biased in favour of elite circles that had fostered projects that were not always in alignment with public interests. Hence, especially after the financial crisis, the influence of financial interest groups on policy-making has been under continuous scrutiny. Much academic research has questioned how interest groups organize for the purpose of influencing public decisions, how they accomplish such goal, and what are the features accelerating their path to political lobbying. This paper aims at investigating the close relationship between the high corridors of corporate and regulatory power during the years preceding the financial crisis. The influence of financial corporations on public decisions as well as the political economy and its measures to attract the financial services sector are questioned. In light of the reflections on the past and present relationship between private and public, one section is dedicated to the options for regulating the role of the financial system to serve the interest of the public sector. Advantages and disadvantages of the different proposals that personalities from the public and private sectors propose are analyzed. Given the fact that the ideas proposed may have methodological constraints in their realization, the last section questions whether it is at least possible to reduce society's dependence and its primary needs from the financial market.

Instilling Values in Financial Markets

The High Circles of Finance: The Convergence of State and Corporate Power

As commentators debate the adequacy of the ongoing financial sector reforms and lobbyists challenge regulators with alarming figures associated with its implementation—Accenture (2010) suggests that implementation of the Frank Dodd Wall Street Reform Act will cost the industry US$3 billion to US$5 billion over 2011–2013—this chapter argues that stakeholders are overlooking an important fact. Regulatory reform can only be successful if it influences the elite sources of power and responsibility within the financial system. Hence, the question at hand is if the responses to the 2007–2008 global financial crisis have identified the configuration of financial sector power well enough to reform the system, for the mindset and values of these elite sources are as important to the success of these reforms as market dynamics and macroeconomic policies. And if we cannot change the mindset and instill fundamental social values in these powerful sources, societies need to lower their dependence on the financial sector for the delivery of essential social services and environmental sustainability.

What we have learned in the run-up to the global financial crisis is that deregulation over the last 20 years did not increase the power of financial corporations and reduce that of government, but it did contribute to their convergence. As forensic accountant and securities fraud export Thomas Myers (2011) argues in his paper *Wall Street Abuse and Regulatory Complicity*, "US regulators have been essentially partners with the same corporate community that designed the structured sub-prime abuse." Similarly, Dean Baker (2010) suggests, "The line in Washington is that if you want to talk to someone from Goldman Sachs, call the treasury department."

To shed more light on how corporate and regulatory power has combined, we need to go back and examine the characteristics of the financial sector prior to the 2007–2008 global financial crisis. In the United States, since the Glass Steagall Act was repealed and restrictions across commercial and investment banking business lines were removed, financial corporations gained greater freedom to exploit the legal loopholes that allowed some of their activities to be exempt from meeting capital adequacy requirements. They could quickly move assets across markets, which in turn increased risks and volatility. They could also repack regulated products and move them off the books. Through securitization and instruments such as collateralized debt obligations (CDO), risks on loan default could be distributed to other parties and be used as the subject matter of secondary and further markets (for example, CDOs on CDO) (Tett, 2009). Financial corporations also began to develop new instruments to diversify risks and substantially increase their lending and borrowing. Derivatives markets, which were preliminarily developed to provide for hedging on commodity prices, expanded to include credit-based instruments. They also gave rise to secondary markets such as credit default swaps. These innovations prompted banks to create an array of shadow banks and special purpose vehicles onto which they could offload and off-shore risky assets. Lehman Brothers were utilizing around 2,985 legal entities at the time of their demise (Valukas, 2010). Indeed, there was large-scale exploitation of both the purpose of a corporation and fundamental fiduciary trust between actors in the investment chain.

But the crisis also revealed that regulators were not totally unaware of these risky practices. Regulators had the mandate to examine new instruments and information on trades was being provided to them. Why then did they fail to act? For one, in many jurisdictions, supervision and regulation of the financial sector was spread across a number of agencies with very little organization and coordination between them. In addition, in the United States, budgets of regulatory agencies were severely curtailed, which lowered their capacities to intervene. Most importantly, however, is

that there was a raft of international and national rules that allowed corporations and banks to monitor their activities and determine their own requirements on risk exposure. For example, under Basel II,[1] banks were permitted to use their own models to estimate credit risks. Smaller banks that had no resources to operate in-house models were to adopt the "standardized approach," which was based on external credit ratings provided by commercial rating agencies. In the United States, the Commodity Futures and Modernization Act of 2000 gave additional privileges for financiers to manage their own risks. The augments presented in favour certainly included the need to let the invisible hand of the market take its course, but the dependence of politicians on corporate contributions had an influence too. There has also been quite some literature on closed door, informal meetings between government officials and corporate captains that took place to negotiate response strategies in the years before the global financial crisis. In *Fool's Gold*, Gillian Tett documents one such instance in 2004, when the Federal Securities and Exchange Commission gave banks permission to lower the capital they had to keep in reserve against the risks of credit default obligations, which enabled them to increase their leverage quite substantially.

The above indicates that there is a very close relationship between the high corridors of corporate power and corporate regulation, both at national and international levels. Indeed, the biographies of the leaders of regulatory agencies on both sides of the Atlantic and also the Bank of International Settlements and the Financial Stability Board, demonstrate that the same individuals move from one position of power to another, criss-crossing between regulatory agencies and financial corporations. The financial sector is thus being manipulated by an elite group of insiders in both government and the private sector. As a result, the social and economic purpose of banking and finance is being eroded to serve the interest of a few at the expense of the majority.

There is also the phenomenon of globalization at work. When financial trades cross boards, regulators face issues as different rules apply across different jurisdictions. Given the complexity and volatility of financials flows, coordination across it gives rise to very complex and technical challenges. Some progress has been made in the harmonization of financial reporting standards, but this now seems like a drop in the ocean given the expansion of the shadow finance sector and the uncertainties this involves.

It is important to note that the political economy is also at play. Countries are vying to attract the financial services sector and are offering them a range of bewildering investment incentives—from long-term tax holidays, attractive interest rates, floated exchange rates and a complete waiver on capital movement restrictions. Today the flow of speculative funds is far higher than foreign direct investments. According the Economist Intelligence Unit (n.d.), global foreign direct investment inflows in 2007 were US$1.5 trillion, while speculative capital was over 10 times that value. When governments have tried to control capital flows, they have been pressured by international bodies (that are closely guarded by industrialized countries and their specialist interests) to liberalize and deregulate. Consider the policies of the International Monetary Fund and the World Bank during the 1998 Asian financial crisis, when they forced the affected economies to liberalize as foreign creditors (especially traders and hedge funds) withdrew their money at a very fast pace. Moreover, these governments were not allowed to support local businesses and wide-spread economic strife was viewed as a necessary adjustment (Raghuram, 2010).

[1] Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision

State support for unfettered financial flows is also evident in bilateral investment treaties and in the investment chapters of free trade agreements that the United States and the European Union have been establishing with lower income countries. The United States uses a boarder definition of investment that runs beyond foreign direct investment to include speculative trade. These treaties provide investing firms with protection against expropriation, guarantees fair and equitable treatment and provisions for international arbitration—the right of investors to take complaints directly against states to international tribunals. Arbitration tribunals are developing jurisprudence governing the extent to which investor rights can to be infringed upon when a state takes action to protect or enhance public interest through regulatory upgrades and other emergency measures. Meanwhile, the World Trade Organization has left the liberalization of investment largely out of its multilateral agreements; the downfall of the Organisation for Economic Co-operation and Development Multilateral Agreement in Investment is a particular case in point.

Getting the High Circles of Finance on the Right Side of the Law

These arguments make a compelling sketch of how government and special interests have combined to globalize and liberalize the financial sector to serve the interests of elite circles. Indeed, indicators of this are even more evident after 2007–2008, when politicians and officials negotiated with leaders of healthier firms to take over weaker ones. With the injection of public funds in the hundreds of millions, societies now have to face the risks of even larger and ever more systemic financial institutions. While they provide a clear point of contact for regulation, they also yield even greater influence over how supervision and regulation is designed and to what extent it might be enforced.

The challenge is therefore to not only make rules that will bring about more systemic stability and render safer the global financial system, but make rules that will also solicit the cooperation of these special interests in power. The financial system is far too complex to be governed by narrow directives, and, as the sector is so highly specialized, technical and complex, inputs from experienced insiders are critical. But can the financial sector indeed be regulated? A large number of commentators point out that all and any attempts to regulate will lead to even further innovations in financial instruments. Indeed, the financial press is agog with stories of those that are working around the new rules even as their rollout barely begins. Is the challenge, therefore, to get these elite powers on the right side of the law? And how might this be achieved?

In the aftermath of the crisis, the focus was on the fact that convergence across the industry had heightened competition and financiers were driven by the demand for the higher return in the shortest term. Commentators called for an end to short-term performance bonuses and salaries that were way above that of other highly skilled professions (Clark & Wearden, 2010).

Some commentators have touted the need to end financialization itself. They argue that most derivate instruments have no social purpose or gain. They point out that a large portion of financial innovation are the products of master mathematicians who are seeking the ultimate formulae to eliminate risks and who are playing them out using extremely advanced computer technology. Commentators suggest that in this virtual world, where speed and affect rule and personal contact is minimal, it is easy for individuals to lose their sense of moral judgement and overlook the human variable in the way markets behave.

Another view has been to focus on reinforcing fiduciary duty between and across all actors in the financial system. This is important, as it is the collective and multiplier impacts of all these actors together that gives rise to systemic risks. And instilling fiduciary duty needs to begin with the core—the elite sources of power—or the effort will be lost. For

example, in the case of the subprime crisis, while local municipalities may have made very poor investment decisions, the demand for toxic products substantially increased when banks at the core invented the secondary markets to disperse their own responsibilities. Day traders that are remunerated on short-term performance are not so much at fault as those that established and operate these incentives in the first place. Is it not important to address the motivations to go offshore rather than simply persecute the governments of offshore heavens?

Reinforcing fiduciary duty would therefore require an in-depth analysis into the norms and values of the corridors of financial power and, moreover, on the conditions under which they might exercise this power without taking responsibility for the individuals and communities that they effect. It might be necessary to discern between the economic and cultural motivations of these elite circles and thus find an explanation for their "culture of irresponsibility," as it was described by President Obama in June 2007. Indeed, this might also help reformists find a point of departure of instilling fiduciary responsibility. For ethical conduct is not a product of automated and impersonal technology, but it is the outcome of lifestyles, values and ethics.

Reformers have already begun work to address some of the key sources of influence of these elite groups, from business schools to research centres and professional associations, and from lobby groups to philanthropic foundations. Reformers also propose the need for a professional ethic, and the United Nations-backed Principles of Responsible Investment might be an ideal starting point.

Another idea where buy-in is increasing is a strategy for negative licensing, a system that would monitor and even remove the rights of a financier from practicing if their performance was deemed to be one that exacerbates systemic risk and is not in alignment with public interests. For such a system to work, the penalty would need to be the loss of social privileges and even ostracism, rather than simply the right to practice (Braithwaite, 2010).

Reducing Dependence on the Financial Markets for Essential Services

All these ideas have technical restrictions. And indeed, reformers might be naïve to even suggest that such a fundamental change of values can even be envisaged. Jim Hardesty, president of Hardesty Capital Management, claims: "The lobbyists are firmly in control of Washington, and the reform efforts are likely to be modest," adding that Wall Street firms might simply "reinvent themselves" (quoted in Clark & Weardon, 2010). Crises are, after all, an inherent feature of capitalism and systems cannot always operate at equilibrium; they constantly embed the potential to disintegrate. Therefore, stakeholders need to reduce their expectations that regulation and supervision can prevent another crisis and correct the market failures that lie at its core.

The solution then would be for societies to reduce their dependence on financial markets for critical services including health, education, transport, energy and food (Arup, 2010), for it is exaggerated to say that all of society benefits from financialization. If the claim is that new financial innovations help to lower risks and enhance price discovery, in practice, it also appears to help shift risks to those that are most ill-equipped to deal with them. It was the taxpayer—including middle- and lower-middle-income earners—that paid the biggest bill of the global financial crisis (Watchman & Lewis, 2011). The ensuing sovereign debt debacle is affecting not only those who had bought into toxic products, but homes, workers and businesses in the real economy, who have no access to employment or credit except on very prohibitive terms.

Reducing dependence on the financial services industry would call for a better balance between public and private service provision through almost a political and social pact. Such a pact could involve not only the high circles of finance, but also the real economy: producers, communities, unions, consumer groups, non-government organizations and charities. In other words, capitalism needs to also serve, even in an unequal manner, the rights and aspirations of society as a whole. This can only be realized through globally coordinated but locally focussed action (Brown, 2010). It also calls for braver government that is able to fashion the much-needed legal frameworks that will provide for the sharing of risks and responsibilities between public and private actors. Such partnerships could also be instrumental in raising the status of social progress and environmental sustainability to a similar level that financial instruments enjoy today. They can also include requirements for financiers to comply with prudential financing and responsible investment principles. Such ideas and principles are indeed alive today, but sit at the periphery of the financial system.

> *Morals are not made and cannot be made by markets. We must affirm that markets are in the public interest but not be automatically equated with it, be honest that the fault is not with markets but with the dogma that markets alone are all we need, and act on the truth that markets cannot flourish or even survive by market forces alone and demonstrate by the standards we insist upon that markets are free but never again values-free.*
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> —Gordon Brown, Beyond the Crash (2010)

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