FINANCE WATCH CAMPAIGN "CHANGE FINANCE!"

FINANCE RULES THE WORLD. LET'S CHANGE THE RULES!

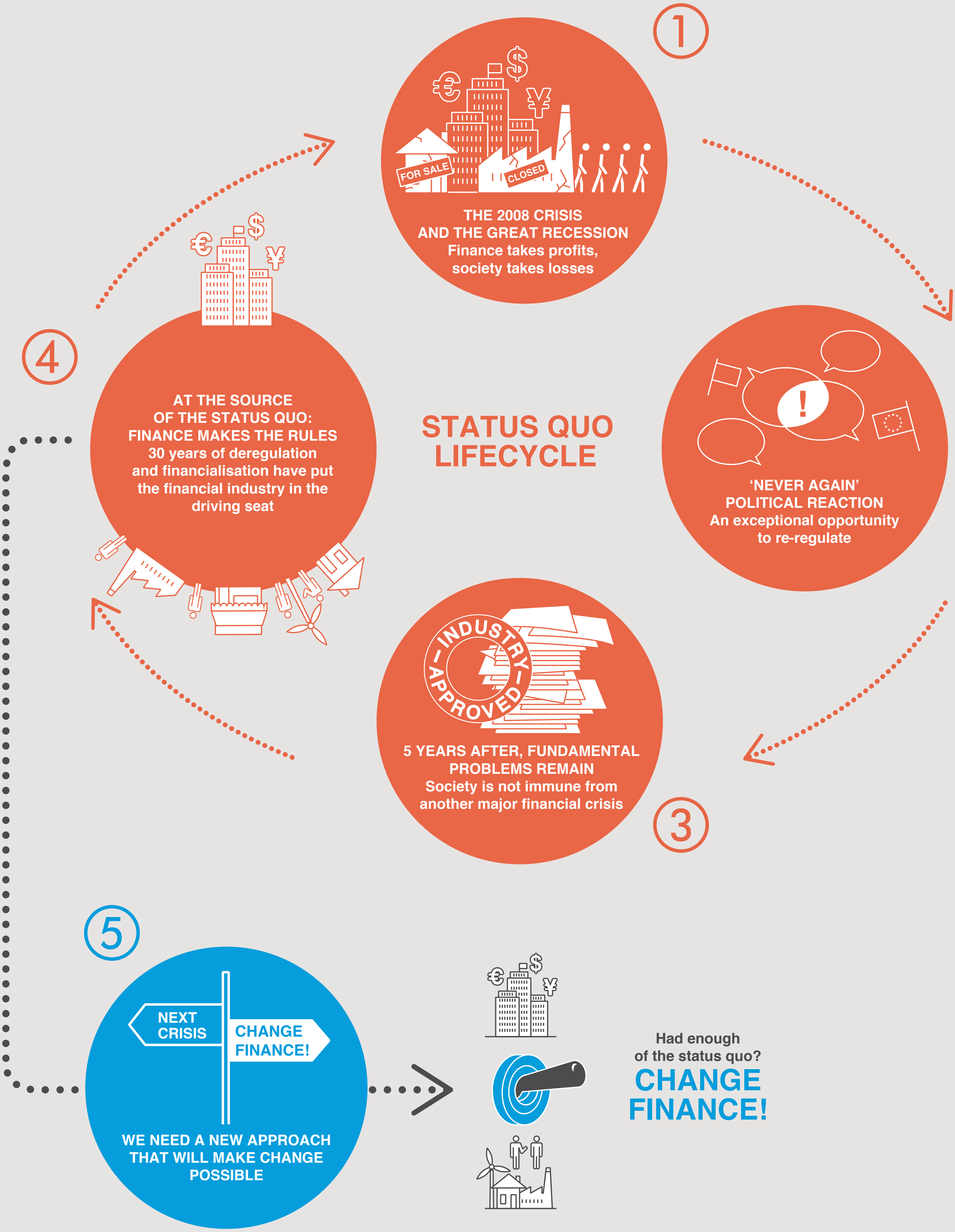
Five years after the collapse of Lehman Brothers the financial system has not been transformed: banks and derivatives markets are bigger than ever, manipulation makes for frequent headlines and productive investments seems the exception instead of the rule. Systemic risk is more a threat to society today than in September 2008.

IT'S TIME TO FLICK THE SWITCH: instead of finance writing its own rules, society needs to write them.

Only then can finance become safe and good for society. To learn more about the dangers in our financial system and what you can do about them, explore these pages and join our campaign.

WWW.FINANCE-WATCH.ORG/HOT-TOPICS/CAMPAIGN-CHANGE-FINANCE

THE STATUS QUO LIFECYCLE



THE 2008 CRISIS AND THE GREAT RECESSION

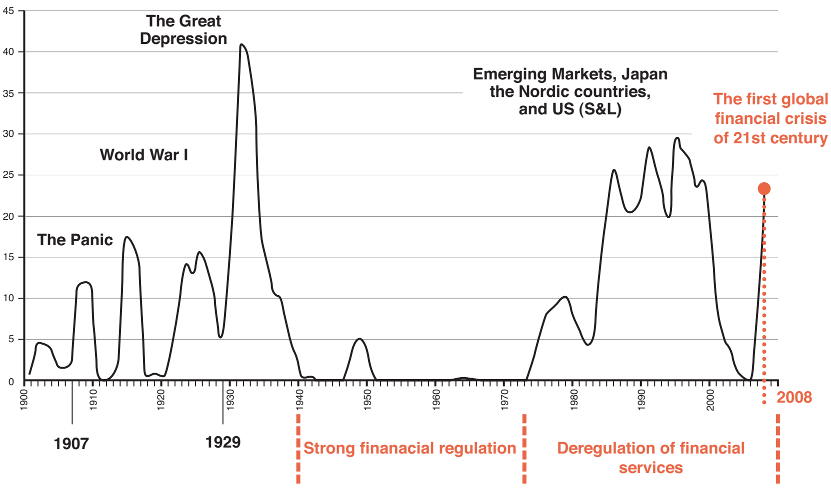
1

Finance takes profits, society takes losses

1

A largely self-regulated financial system has proven over the **last 30 years** to be **unstable.**

Proportion of Countries with banking Crises, 1900—2008
Weighted by Their Share of World Income



FINANCIAL CRISES FREQUENCY AND IMPORTANCE
(source: Reinhart and Rogoff - 2008)

2

Five years ago, the financial system **nearly collapsed** altogether, saved only by **massive public intervention.** The worst financial crisis since 1929 proved that the current system is **unsustainable**.

€ 1.6 Trillion
(13% of EU27 GDP)

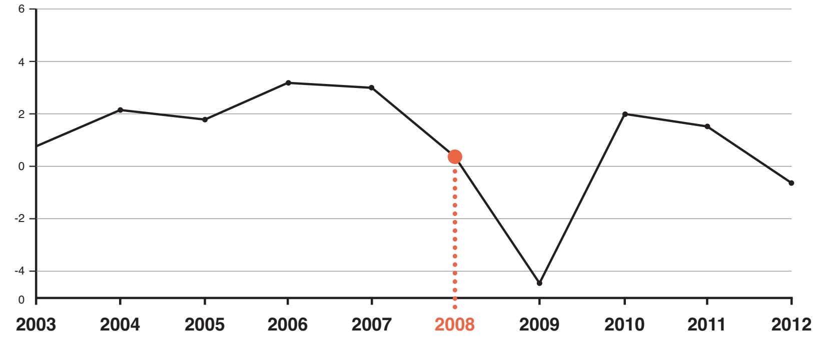
TOTAL AID TO BANKS USED BETWEEN 2008 AND 2010 IN EU27
(source: Liikanen report)

3

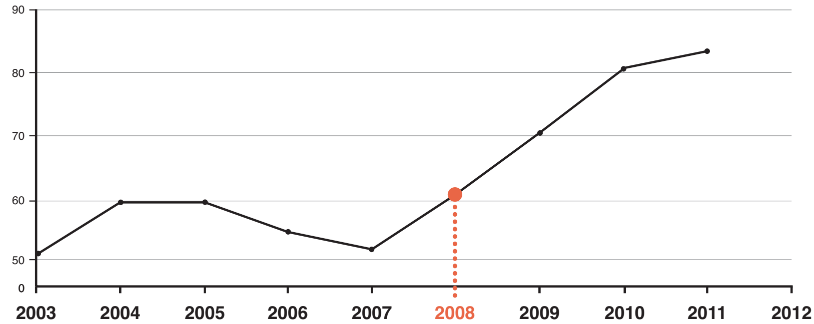
The '**Great Recession**' quickly followed, **stopping economic growth** in Europe and beyond for years. Fiscal deterioration and bank bailouts have sent **public debt soaring** around the EU, burdening ordinary EU citizens for decades to come.

> "*In April [2009], we confronted the greatest challenge to the world economy in our generation. Global output was contracting at a pace not seen since the 1930s. Trade was plummeting. Jobs were disappearing rapidly.*"

G20 LEADERS' STATEMENT, PITTSBURGH SUMMIT, SEPTEMBER 2009



GDP EVOLUTION, EURO AREA
(source: World Bank)

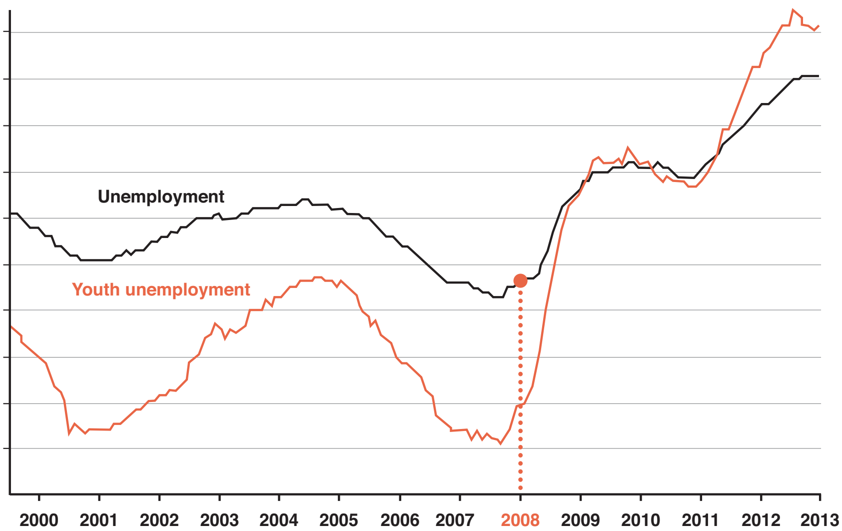


CENTRAL GOVERNEMENT DEBT, % OF GDP, EURO AREA
(source: World Bank)

4

Unemployment has reached record-highs, especially among the young. **Poverty** levels in the EU have risen and the EU's external **development aid** has been slashed.

> *"We recognise the human dimension to the crisis."*
>
> ***G20, LEADERS' STATEMENT, LONDON SUMMIT, APRIL 2009)***



UNEMPLOYMENT AND YOUTH UNEMPLOYMENT, EURO AREA
(source: Eurostat)

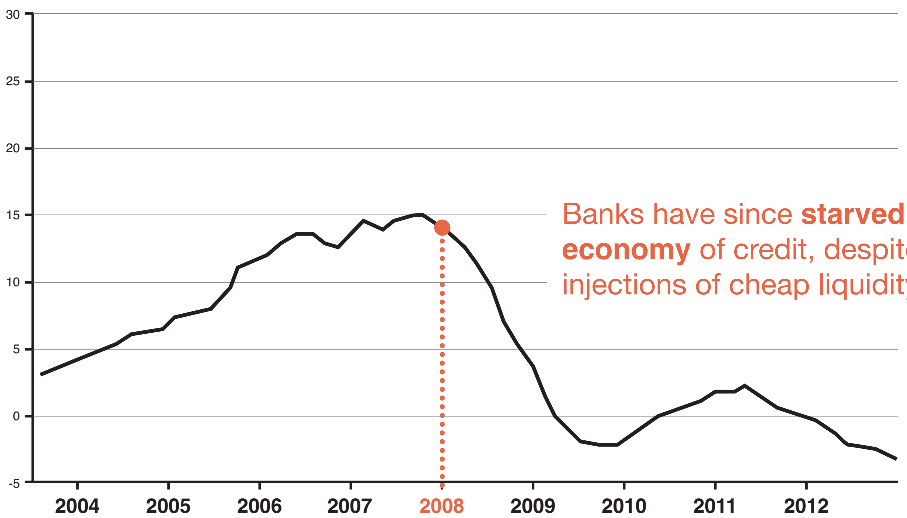
These social costs followed historically **high profits** in the **financial sector**.

5

It is not an easy task to convince the electorate that the future losses must be nationalised, when the past profits were privatised".

LORENZO BINI SMAGHI, MEMBER OF THE ECB'S EXECUTIVE BOARD, 20 OCTOBER 2008

PROFITS OF 16 EU BANKS, AFTER TAX AND OUTSIDE EQUITY INTEREST
(Source: Reserve Bank of Australia)



Banks have since **starved the real economy** of credit, despite massive injections of cheap liquidity by the ECB.

6

LOANS TO NON-FINANCIAL CORPORATIONS, ANNUAL GROWTH RATES, EURO AREA
(source: ECB)

‘NEVER AGAIN’ POLITICAL REACTION

An exceptional opportunity to re-regulate

2

1

As panic spread through the financial system from September 2008, **world leaders** rallied to assure the public that it would **never happen again.** At the Pittsburgh Summit in 2009, G20 leaders condemned the “era of irresponsibility” and promised new regulation to rein in “the excesses that led to the crisis.”

“We will not allow a return to banking as usual.”
(PITTSBURGH LEADERS’ STATEMENT)

“History cannot be allowed to repeat itself.”
(BARACK OBAMA)

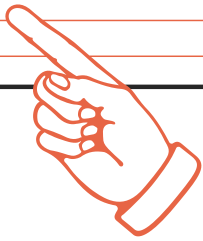
“Nothing less than a global change is required”
(GORDON BROWN AND NICOLAS SARKOZY)

“We must show zero tolerance for any return to the «bad old ways»”
(JOSÉ MANUEL BARROSO)

2

An **international plan of action for financial reform** was drawn up, inspiring hundreds of regulatory initiatives in the years that followed. The action plan focussed on some key areas, including:

- Bank capital
- Financial sector pay
- Over-the-counter derivatives
- Cross-border resolution plans for banks,
- Shadow banking
- ????
- ???



3

But it did not **question the 'self-regulation' principle** that had guided regulators since the early 1980s. Nor did it **question the core purpose, structure or size** of today's financial services sector. As a result, the changes we have seen since are mainly superficial.

4

Leaders also needed to fix the **budget deficits** that the financial crisis had blown up. As they needed the banks to help with sovereign funding, **the window of opportunity for real change in the financial sector was soon closed.**

EXTRACT OF DOCUMENTARY - 'INSIDE JOB':
FORMER IMF HEAD DOMINIQUE STRAUSS-KAHN RECALLS A DINNER AT WHICH TOP BANKERS, FRIGHTENED BY THE CRISIS, BEGGED FOR MORE REGULATION TO HELP THEM CONTROL THEIR OWN GREED
(source: http://www.youtube.com/watch?v=3wGSELiDx40)

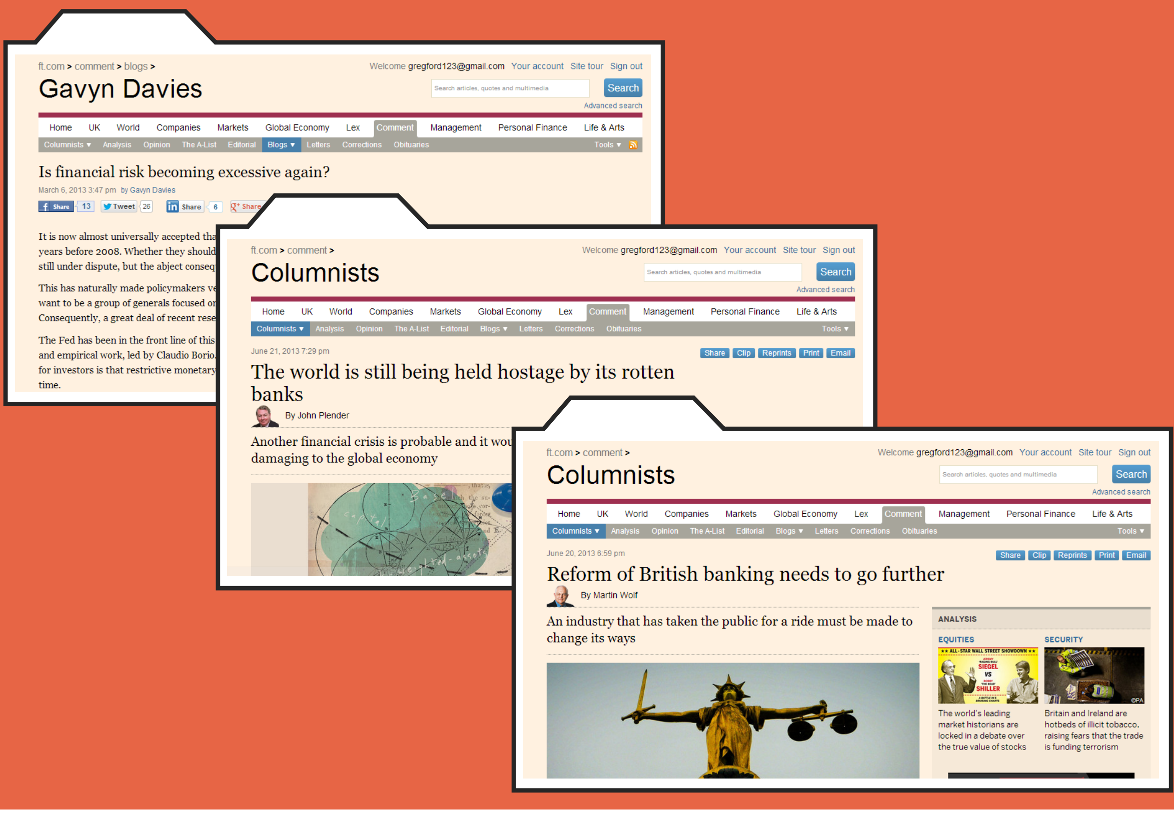
5 YEARS AFTER, FUNDAMENTAL PROBLEMS REMAIN

Society is not immune from another major financial crisis

1 Officials at international, European and national level have deployed skilled resources to produce policy documents, new standards, regulations and supervisory codes. New oversight institutions have been created. There are also signs that some of these bodies recognize the weaknesses of ongoing reforms. **These are positive developments** that lay the ground for the urgent deepening and speeding up of the reform process.

2 **But has the system fundamentally changed?**
The overwhelming answer is **no.**

> *"Nearly five years after the bankruptcy of Lehman Brothers touched off a global financial crisis, we are no safer. Huge, complex and opaque banks continue to take enormous risks that endanger the economy."*
>
> ***(PROFESSOR ANAT ADMATI NY TIMES, 25 APRIL 2013)***



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Is financial risk becoming excessive again?
March 6, 2013 3:47 pm by Gavyn Davies

It is now almost universally accepted tha…
years before 2008. Whether they should…
still under dispute, but the abject conseq…

This has naturally made policymakers ve…
want to be a group of generals focused o…
Consequently, a great deal of recent rese…

The Fed has been in the front line of this…
and empirical work, led by Claudio Borio…
for investors is that restrictive monetary…
time.

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The world is still being held hostage by its rotten banks
By John Plender

Another financial crisis is probable and it wou…
damaging to the global economy

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Reform of British banking needs to go further
By Martin Wolf

An industry that has taken the public for a ride must be made to change its ways

ANALYSIS
EQUITIES
The world's leading market historians are locked in a debate over the true value of stocks
SECURITY
Britain and Ireland are hotbeds of illicit tobacco, raising fears that the trade is funding terrorism

3 Why do we say this? Some facts:

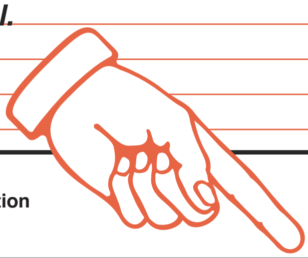
- *The EU's economy is* ***more 'financialised' than ever,*** *with total assets (=size) of EU financial institutions now more than* **350% of EU GDP.**

- ***Bank leverage remains historically high,*** *on average between 30x and 35x when most experts agree that a safe financial system should be leveraged no more than between 15x and 20x.*

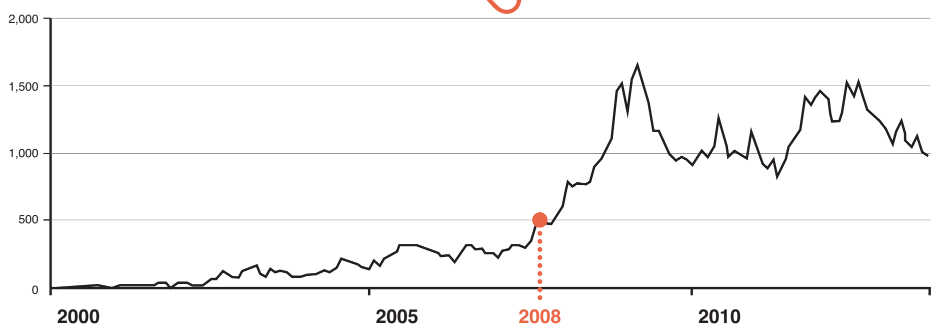
- *Banks are still* ***too-big-to-fail.*** *The Financial Stability Board (FSB) counts 28 global systemically important banks on its list.*

- *There are* ***more derivatives traded now than before the crisis.*** *The notional amount outstanding (=size) of the over-the-counter derivatives markets has increased from $596 trillion in December 2007 to $632 trillion in December 2012, equivalent to* ***nine times world GDP.***

- ***The systemic risk*** *of EU financial institutions (SRISK, measured as their capital shortfall in case of a new financial crisis)* ***is double*** *what it was in September 2008. Experts at CRML estimate that the € 43 trillion banking system in Europe is still* ***short of € 1 trillion of capital.***



European SRISK evolution



SYSTEMIC RISK MEASURE FOR EUROPEAN FINANCIAL INSTITUTIONS, IN BILLION EUROS.

(Source: Center for Risk Management at Lausanne (CRML), University of Lausanne. Public data, model by Jondeau, Rockinger and Nobel Laureate Professor Robert Engle)

4

The only structural component of the system that has improved is **the ratio of bank capital to risk-weighted assets,** but the reliability of this measurement has been challenged by regulators (source: FSB), warning that there are significant discrepancies in the way banks calculate risk.

Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability
Report of the FSB to G20 Leaders (5 septembre 2013)

Both studies indicate considerable variation across banks in the risk weighting of assets, even for identical hypothetical test portfolios. While some variation in RWAs is natural and desirable, reflecting differences in banks' assets composition, business models and risk preferences, there is also material variation driven by diversity in bank and supervisory practices that diminishes the comparability of reported regulatory capital ratios and could be harmful to the international level playing field.

5

Meanwhile, the catalogue of **banking scandals** never seems to end: money laundering; LIBOR and other price manipulations, the London Whale and rogue trading scandals, miss-selling of swaps and insurance …

UBS trader Adoboli held over $2bn loss - *FT*

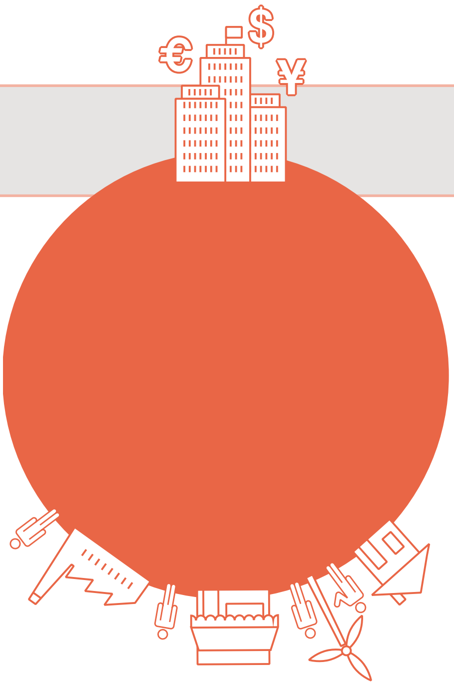
Swaps Probe Finds Banks Rigged Rate at Expense of Retirees
- *Bloomberg*

U.S. Bank Legal Bills Exceed $100 Billion - *Bloomberg*

Serious Fraud Office to investigate Libor manipulation
- *The Guardian*

Barclays boss Bob Diamond resigns amid Libor scandal
- *BBC NEWS business*

Rale swap scandal: RBS mis-selling bill may exceed £1bn - *The Telegraph*



AT THE SOURCE OF THE STATUS QUO: FINANCE MAKES THE RULES

4

30 years of deregulation and financialisation have put the financial industry in the driving seat

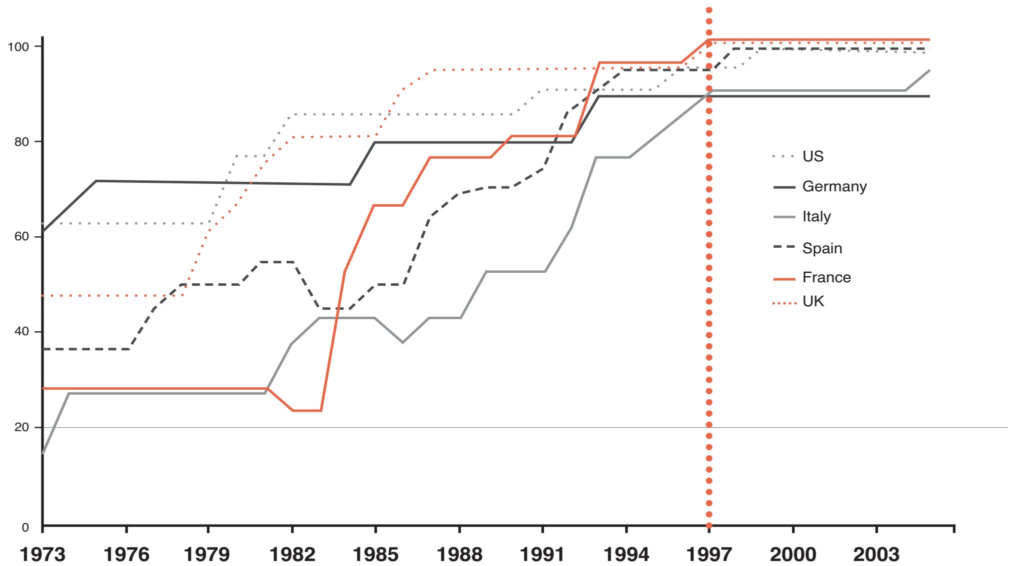
1

What is missing in the reform agenda – going back to the social purpose of the financial system and measuring the effectiveness of the current financial industry in fulfilling that purpose – is missing for a very good reason: **it has been left to the industry to define its own purpose and rules, and it has been assumed that such self-regulation would necessarily lead to benefits for society.**

Related to this is an assumption that finance naturally serves society.

2

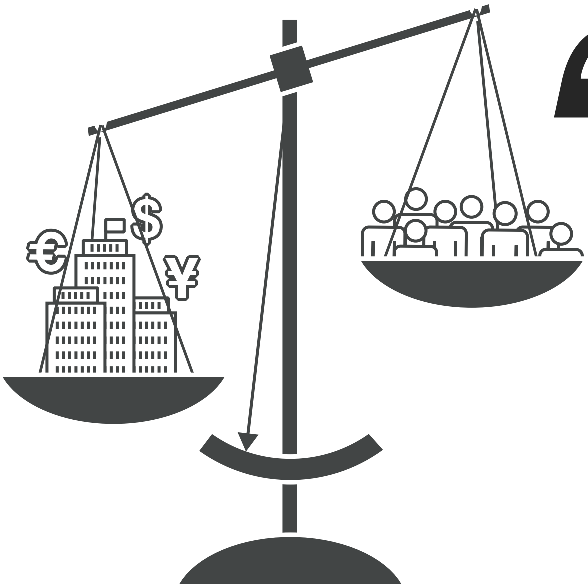
These ideas have led to market **liberalisation:** regulations were removed or harmonised to the lowest common denominator, and the financial industry was gradually **deregulated.**



THE IMF'S 'LIBERALISATION INDEX' SHOWS A CLEAR TREND TOWARDS 'FULL LIBERALISATION' IN ALL WESTERN, DEVELOPED COUNTRIES BETWEEN THE 1980S AND THE EARLY 2000S
(IMF, 2008)

3 **Deregulation** helped the financial sector to grow much faster than the economic activity that supports it, a process called **financialisation**. For example, between 2001 and 2011, the balance sheets of European banks rose by 80% while the EU's GDP increased by only 30%.

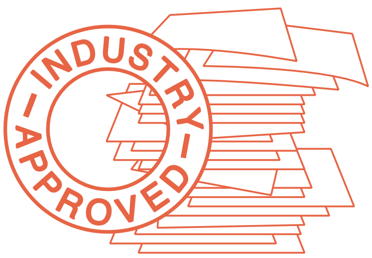
4 Financialisation brings increased **power and political influence** to the financial sector.



"The balance of power between protagonists is in fundamental disequilibrium: on the one hand the globalised world of finance dominated by a limited number of large multinational actors…, on the other public authorities... who appear particularly timorous each time they are called to confront the financial sector."

(PAUL GOLDSCHMIDT, FORMER DIRECTOR AT GOLDMAN SACHS, FORMER DIRECTOR AT THE EUROPEAN COMMISSION)

5 And as finance is assumed always to benefit society, politicians have learnt to defer to the industry **for fear** that any 'non-industry approved' regulation might **damage the real economy.**

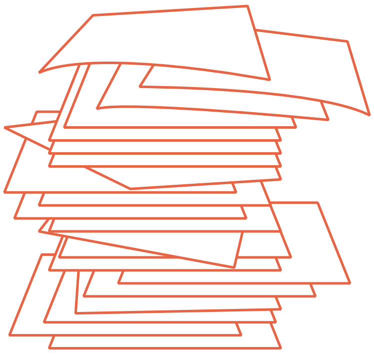


"Government leaders are gripped by one overriding fear: that their economies will slip back into recession – or worse. The big banks play on this fear, arguing that financial reform will cause them to become unprofitable and make them unable to lend."

(SIMON JOHNSON, FORMER CHIEF ECONOMIST AT THE IMF).

6

Financialisation also brought new levels of **complexity** to the industry. Regulators have tried to keep up, but with mixed results.



"Modern finance is complex, perhaps too complex. Regulation of modern finance is complex, almost certainly too complex. That configuration spells trouble."

(ANDREW HALDANE, DIRECTOR FOR FINANCIAL STABILITY, BANK OF ENGLAND)

7

Hemmed in by fears of hurting the economy and a dependence on industry expertise, policymakers are recognising that the **financial lobby** has become too strong. As Europe's top financial regulator said after the crisis:

"We need to remember that it was many of those same lobbyists who in the past managed to convince legislators to insert clauses and provisions that contributed so much to the lax standards and mass excesses that have created the systemic risks."

(CHARLIE MCCREEVY, EU COMMISSIONER FOR INTERNAL MARKET AND SERVICES, FEBRUARY 2009)

"Nearly all the lobbyists for financial services came from the financial industry. So let me thank Finance Watch. You understood at an early stage that lobbying must be balanced to lead to a democratic outcome."

(MICHEL BARNIER, EU COMMISSIONER FOR INTERNAL MARKET AND SERVICES, MARCH 2012)

8

Five years after the crisis, the financial lobby continues to be very **successful in fighting regulation.**

"From Washington to Berlin, banking lobbyists have blocked essential reforms at every turn."

(PROFESSOR ANAT ADMATI, NY TIMES, AUGUST 2013)

NEXT CRISIS
CHANGE FINANCE!

WE NEED A NEW APPROACH THAT WILL MAKE CHANGE POSSIBLE 5

1 A clear alternative with opposite consequences:

EITHER

- ***More of the same:*** *the next major financial crisis could be around the corner. We know what that would mean for social and economic conditions, and trust in the financial sector. It could also feed euro-scepticism and political extremism.*

OR

- ***Change the rules to put society in charge.*** *Imagine if we had a stable financial system that genuinely served society's needs, if the EU's citizens trusted their leaders always to prioritise them ahead of the financial industry and private national agendas, if the public started to trust and respect the financial sector again, if finance started to fulfil its potential to be one of the great tools for solving the problems of the 21st century.*

NEXT CRISIS
CHANGE FINANCE!

2 Alan Greenspan famously confessed that his faith in the self-regulation principle had been shaken by the global financial crisis:

> *"Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."*
>
> ***(TESTIMONY TO THE HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM, OCTOBER 2008)***

Shock is not enough: **a change of paradigm is needed.** The current thinking gives too much power to the financial industry and makes politicians afraid of fundamental reform. New thinking is needed for society to break free from the cycle of financial crises. In Finance Watch's view, the new paradigm should reflect what we have learned in the crisis:

3

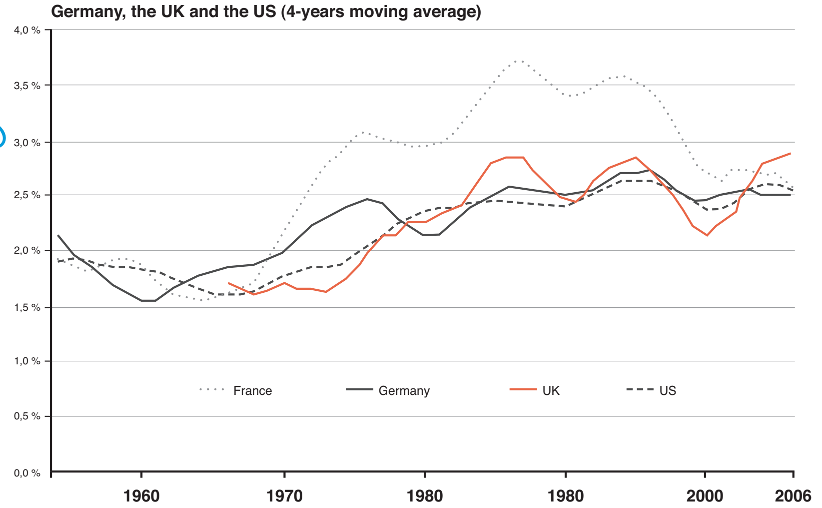
Finance does not naturally serve society.
For this to happen, society must set the rules

4

The old paradigm was based on ideology and theory.
The evidence of its impact on the real world shows its limitations:

- ***Liberalisation and deregulation in the financial industry lead to decreased efficiency,*** *i.e. a higher cost for the same service (or higher 'unit/cost'). This increased inefficiency has been measured for the US financial industry by Thomas Philippon of NYU. In research sponsored by Finance Watch, his demonstration has recently been replicated for Europe with the same preliminary results: financial services are more expensive today than prior to the start of deregulation.*

Unit cost of financial intermediation in France, Germany, the UK and the US (4-years moving average)

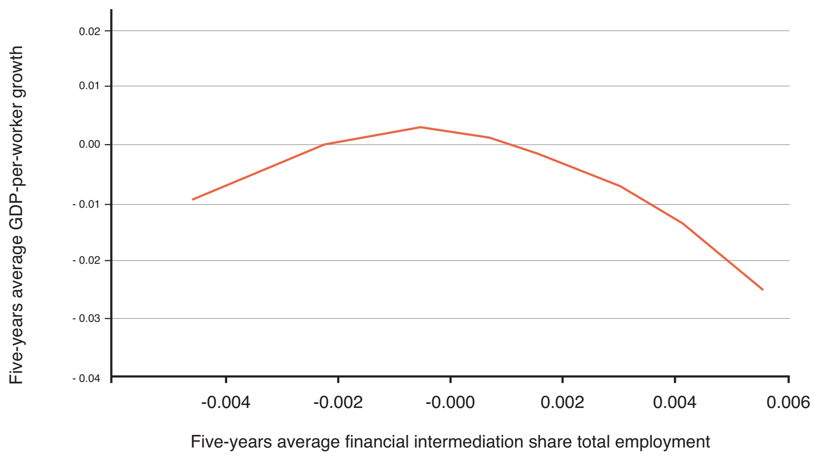


Source: Institut des Politiques Publiques, Guillaume Bazot

- ***Financialisation above a certain level is detrimental to growth*** *– this level has now been reached in all developed economies.*

> *There comes a point where further enlargement of the financial system can reduce real growth”*
>
> ***(CECCHETTI AND KHARROUBI)***

Financial sector share un employment and growth



Source: BIS working paper, Cecchetti and Kharroubi, 2012

- *Importantly, the previous two facts do not take into account* ***negative externalities*** *in the form of recurrent, worsening crises over the last 30 years…*

5

A new paradigm would recognize that in the financial industry and elsewhere, **people act in response to social and institutional incentives and constraints.** And these reflect the interests of whoever creates the rules of their environment. For example, it might be ‘rational’ for a bank executive to engage in extreme risk-taking activities in an investment bank environment that rewards such behaviour regardless of the consequences for society. The same executive would be ‘irrational’ to do this in an environment where their risk-taking were condemned and penalised.
The difference lies in the rules that define that environment.

OUR KEY RECOMMENDATIONS CONTRIBUTE TO MAKING THIS PARADIGM SHIFT A REALITY:

WWW.FINANCE-WATCH.ORG/HOT-TOPICS/CAMPAIGN-CHANGE-FINANCE/FOUR-DEMANDS