

The Threats Lurking in the Financial Sector



April 2019

"We will not know where the next crisis will start. But it will become a full-blown crisis, with broader global consequences, when we are not prepared for it."

Report of the G20 Eminent Persons Group on Global Financial Governance, October 2018, p.21

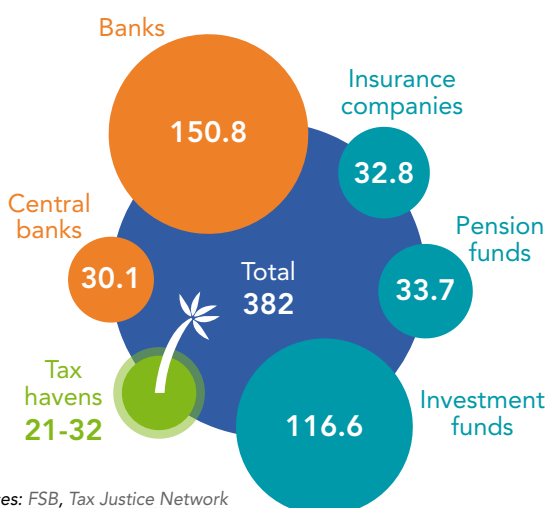
Introduction

The promise to ensure effective regulation of the financial sector to take away the risks that that caused the 2008 financial crisis, has not been fulfilled. Instead new risks are growing in the financial system and experts warn that another financial crisis is inevitable. Nevertheless, deregulation is happening. At the same time, official awareness is increasing that the financial sector without due regulation risks escalating climate change, inequality and many other challenges in society and the economy.

This briefing shortly explains some of the remaining and new risks in the banking sector and the investment industry. It proposes further regulation to make the financial system more stable, sustainable and democratic at the service of societies.

Financial assets

Global financial assets for 2017 in trillion US\$



Sources: FSB, Tax Justice Network

1 The banking sector – too little has changed

1.1 Bank reforms inadequate

The reform of the banking sector, which played a pivotal role in the 2008 crisis, is considered to be 'finalised' in 2019. However, the implementation of certain bank reforms has been delayed until 2022, or watered down, while others are being deregulated. Moreover, bank reforms have been too weak to prevent new risks slowly building up. We have seen how banking crises translate into an economic downturn in which people lose their jobs and their houses, and youth unemployment increases. Bank bailouts after 2008 resulted in governments cutting public spending for health, education and other public services.

Too big to be regulated

There are still (in 2018) twenty-nine global banks that are each so big, complex, and interconnected with other big banks and financial markets, that if they fail, the whole banking and financial system goes into crisis. These so-called global systemically important banks (G-SIBs), or too-big-to-fail (TbTF) banks, have not been downsized and restructured as happened after the previous big crisis (1929-1932).

Bank reforms only require that these G-SIB banks maintain extra capital buffers and a specific plan in case they are no longer able to fulfil their financial obligations, and need to recover or be resolved. The purpose of these regulations is to ensure these banks could go bankrupt without tax payers' money having to bail them out, while guaranteeing basic payment and bank services and protecting savers' money.

However, critics and experts warn that these reforms are unlikely to result in an orderly resolution in case one or more of these big banks were to experience a crisis. Indeed, some of the global banks have actually become bigger and more interconnected since the crisis. What's more, some reforms are being relaxed! This means there is still a real risk that governments will again have to use tax payers' money to bail out those complex banks (the 'moral hazard' problem). If government budgets will not or cannot be used, clients will not be

able to access all their money and businesses will not be able to take out loans, and the economy suffers.

- ▶ Proposals to restructure the G-SIB banks were abandoned thanks to the financial lobby, and need to be put firmly back on the agenda: The bank's basic payment, saving and banking services need to be guaranteed and fully separated from the bank's risky, speculative, off-balance and financial-market activities that should not receive governmental guarantees. Additionally, large banks have to decrease their size and financial market activities, and become less complex and interconnected.

Underregulated and under-supervised

More than ten years after the crisis, the banks have again engaged in risky lending practices (eg, low quality corporate loans) with insufficient capital buffers. In Europe some banks are still sitting on many bad loans and some are so indebted that they can only continue to operate thanks to government guarantees ('zombie banks'). The financial reforms that require all banks to hold bigger, better quality, and more liquid financial buffers have been delayed and are still too little (only €1 for every €33 of credit by the bank).

The international reforms did not require all banks to use a standardised risk assessment of loans to determine the amount of capital buffer they have to hold to deal with defaults. Rather many large banks continue to operate their own internal complex systems to assess the risks, which they can manipulate to put less capital aside or attract clients by less interest. Even if these risk assessment methods are regulated, supervisors are still not able to fully control them. Moreover, supervisors and regulators still do not effectively cooperate with all host country supervisors of global banks and US regulators are relaxing their testing of how risky the banks are. But new risks are arising from new complex financial products and the use of new technology being created (eg, cyber-attacks).

The interconnected and complex banks can still destabilise the financial system and badly affect the economy given the crucial role banks play for businesses, households, and small and developing countries.

- ▶ Further strict reforms are still needed that ensure that banks hold much higher capital buffers and use simple risk assessment processes that do not give them leeway about the capital buffers to hold.
- ▶ Risky lending and new, complex financial products have to be approved by supervisors, or be banned, certainly if there is insufficient supervisory capacity as is currently the case.
- ▶ Supervisors need to be accountable to parliaments about their supervisory activities to prevent banks from being able to destabilise the financial system.

1.2 Banks are not serving society

Only recently has official recognition been growing that the financial reforms did not prevent banks from failing to finance those clients and activities that are most needed in society. Banks are creating money but only around 30% of their balance sheet is used for lending to households and businesses, the rest is used for risky financial market activities and speculative activities that are often socially useless.

In addition, banks serve and finance companies and activities that contribute to climate change and environmental degradation, and breach social and human rights. For instance, between 2009 and 2014, the top 25 global banks lent almost 10 times more to the fossil fuel industry (US\$ 931 bn) than for renewable energy and continued to finance the fossil fuel industry with billions of dollars after the Paris climate agreement was signed. Many banks lend to companies that do not observe minimum international labour rights and that breach human rights by destroying people's livelihoods (eg, palm oil companies).

To date, banks have little to no obligation to finance socially and environmentally sustainable activities. Some regulators have recognised that too much lending to the fossil fuel industry may result in non-repaid loans and financial turmoil in case of rapid climate change and swift abandonment of fossil fuels. Banks do not have to assess climate, 'environmental, social and governance' (ESG) risks and impacts for society, and their current risk assessments methods are inadequate to assess future ESG risks.

Some countries and the EU have rules that require more disclosure of the banks' impact on the environment and society. Such new rules, often weak or non-binding, do not prevent the risk that banks are undermining societies. Banks focus on richer clients at a time when inequality is at a record high, seek short term high profitability while long term sustainable financing is needed, and make as few costs as possible to assess ESG risks and impacts. Rather than financing activities that support the Paris climate commitments and the UN Sustainable Development Goals (SDGs), many banks still contribute to undermining them.

- ▶ New financial laws are urgently needed to ensure that banks prioritise lending that serves the transition to a more socially and environmentally sustainable economy and society for the benefit of all citizens, by:
 - Introducing a legally binding duty on banks to incorporate social and environmental impact in their risk assessments and lending/financing decisions.
 - Prohibiting the financing of unproductive or socially useless activities (eg, lending to speculate on energy prices) and activities which are harmful to climate, environment or society.

- Prudently redirecting financial flows through coordinated international measures and reforms while ensuring banks finance the social and environmental priorities of host countries. Examples are promoting loans for small-scale renewable energy and ensuring inclusive financing for women through services with lower profit margins.

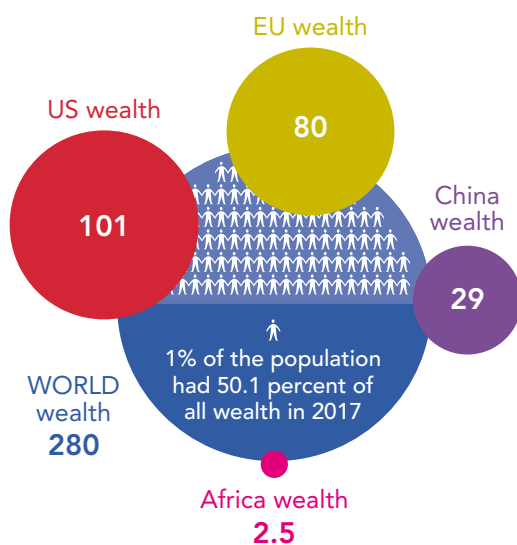
1.3 Banks at the mercy of shareholders

One taboo during the financial crisis was to challenge the fact that banks are listed on the stock exchange and are therefore driven by shareholder value and engaged in huge competition in a free market system. This pressure made them reduce costs of compliance so as to make high annual profits. It also resulted in manipulation and misconduct, and high bonuses for irresponsible risk taking. In the end, banks had to pay high fines (estimated up to US\$ 345 bn by US and EU based banks). In combination with the financial reforms, banks became too often based on the same business model that focuses on high shareholder value without accountability to many more stakeholders and to society.

Again, this is leading to excessive profits (the largest six US banks made US\$ 119 bn in profits – up 18% – in 2018, with higher CEO bonuses) and risky financial innovations. Given that low interest rates result in small profit margins from lending, banks have for instance paid less for employees. Banks that increase staff costs see their share value go down, while when they sack people, share value goes up. In Europe, this resulted in such weak internal controls that billions of dollars were laundered through their banks.

Wealth

Global wealth figures for 2017 in trillion US\$



Source: Credit Suisse

- ▶ The creation of a diverse banking sector with mutual and cooperative banks, stakeholder banks, networks of peoples' banks, ethical banks, green and sustainability banks, local or regional banks, public banks, etc., need to be promoted, and legal or political barriers thereto removed.
- ▶ Banks need to become more democratically governed so as to service all stakeholders, eg, by board members who protect the public interest and employees.

2 Risks in the investment industry

The financial reforms and policies following the 2008 financial crisis resulted in the growth of the investment industry and a subsequent transfer of risks to the financial markets.

2.1 Ever larger interconnected investment funds

After the financial crisis, interest rates were kept low so that cheap loans could stimulate the economy. This meant that savers, pension funds and other institutional investors, like insurance companies, received very low return from their savings at the bank, encouraging them to turn to the financial markets and investment products. In addition, policy makers encouraged investments in company shares and bonds as alternatives to bank loans. Banks started then to increasingly sell investment products to savers, as it earns the bank a fee while the risks of losing money are carried by their clients.

As a consequence, investments in shares and bonds on the stock market and in complex financial products (eg, derivatives) have increased despite the yield being uncertain and volatile. Asset management firms created a variety of investment funds to spread risks by bundling shares of a large number of different companies (up to thousands) into one fund. Some investment funds just follow the stock market value of a fixed series of profitable shares or bonds (index funds, passive investment). Other investment funds issue themselves shares to be bought on the stock exchange (ETFs – exchange traded funds). These funds have enjoyed huge popularity.

Some regulations protect customers from abusive marketing and complexity of the funds. However, there is no regulation to restrict the size of these firms, nor the size of any particular fund. Some global asset management firms now have more assets under management than the largest global banks. BlackRock, for instance, has an estimated US\$ 6.3 trillion under management and Vanguard had \$ 5.3 trillion in 2018. The fund industry competes to offer funds with the lowest management fees, which means that legally obligatory risk assessments might not be sufficiently robust. Investment funds increase the interconnectedness of global financial markets and magnify herd behaviour by investors. Shares in ETFs, for instance, can be sold immediately. A panic in the financial markets can lead to a run on the funds that need to sell their assets, putting downward pressure on the value of other shares and bonds, ultimately leading to

a meltdown of financial markets. The last two years have [seen increasing volatility in global financial markets](#) with investors easily switching investments.

- ▶ New regulations can prevent investment funds from destabilising the financial system by:
 - Regulations that limit the size of fund management companies, the size of an investment fund, the scope of their investments, the interconnectedness and the use of indexes and passive investment strategies.
 - Regulations that strengthen the risk assessments and prolong the duration of the investments in the funds.

2.2 Stop green washing

The investment fund industry is being viewed with increased criticism for ignoring and being non-transparent about its bearing on the environment, climate, company strategies and workers, and society. Many index funds include shares of companies with high profitability without assessing their impact, for example fossil fuel companies.

Some fund managers have created so-called green or sustainable funds but many only meet weak standards and have less impact than their marketing promises, which is known as green washing. This can result in a financial bubble that can burst after investors discover their trust to contribute to a green transition has been abused.

- ▶ By law, all investments should be based on thorough environmental, social and governance (ESG) impact assessments of the financed activities and companies. Investments in activities and companies that increase climate change, engage in socially and environmentally abusive practices and/or corruption and tax dodging, should be banned.
- ▶ Investment funds or products that claim to be green, social or sustainable (eg, eco-labels, green bonds, social impact funds) need to adhere to legally binding and supervised high standards on what activities and companies can be financed.

2.3 Money flashing around

Today various well-resourced speculating firms trade in shares, bonds, and financial products around the world in nano seconds ([high frequency trading](#)) and engage in automated trading using supercomputers and algorithms. They can make huge profits from socially useless trades or even by forcing prices down as is the case in the US\$ 3 trillion hedge fund industry which is based in tax havens.

This has been made possible by one principle that was not reformed after the financial crisis, namely that capital should be able to cross borders without restrictions. In search of higher yields than in developed countries with low interest rates and sluggish economic growth, despite the loose monetary policy by central banks in the post-crisis era ([quantitative easing](#) – QE), bank loans and financial investments to developing countries’

governments and companies soared. However, once central banks in developed countries reversed their monetary policy and interest rates increased, especially in the US, foreign lending and financial investments withdrew from developing countries en masse, for example in 2018. As a result, [the currencies of these countries devaluated](#) and mountains of debts became much more difficult to be repaid. This led to cuts in public spending, a full financial crisis in Argentina, and higher import prices that make people’s cost of living more expensive.

- ▶ Central banks worldwide should improve the coordination and management of cross-border capital flows to adapt to external circumstances and dampen ‘hot’ inflows and outflows before negative effects on developing countries occur. Therefore, international agreements that prevent intervening in cross-border capital flows need to be reformed.
- ▶ Introducing a financial transaction tax, which becomes higher as cross-border and speculative financial flows increase, should reduce the very short term ‘hot’ money and increase income for government spending on long term public interest projects.
- ▶ New financial laws should discourage and prohibit speculative, very short term investments such as high frequency trading, food and energy price speculation, and downward price speculation. What is not banned, must be strictly regulated and supervised.

2.4 Shadow banking

The financial reforms failed to regulate the whole of the complex financial industry. Shadow banking continues to provide financing without being regulated as strictly as banks. For instance, complex instruments that contributed to the 2008 financial crisis are being revived. This includes [securitisation](#) of loans with different risks of non-repayment, bundled in complex ways in financial products that are sold to investors from a lightly regulated jurisdiction. In the EU, securitisation has only been lightly regulated and standardised.

Securitisation and other shadow banking instruments result in non-transparent risks that are liable to change quickly and are not being supervised.

- ▶ Structural changes need to shrink the whole of the shadowy financial industry and reforms need to bring any remaining off-shore financial players and shadow banking activities under strict regulation and supervision.



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