

What We Need is a Preventive Testing of Financial Innovations (“finance TÜV¹”)

Answer to the public consultation of the European Commission on the Liikanen-Report

13th November 2012

“The complexity of a number of financial instruments [...] also explain why problems in the relatively small US sub-prime market brought the global financial system to the verge of a full-scale dislocation.”

de Larosière-Report (2009), p. 13

1 Separating the wheat from the chaff does not get rid of the chaff

“Separating or ringfencing retail or market activities does not improve their risk management nor does it eliminate excessive risk taking – even in traditional retail activities – or the possible involvement of banks in the formation of asset bubbles. It does not address investment banking or market risks either, which may still require a bailout if they turn to be systemic.”

de Larosière (2012)

Not all investment banking is chaff; it is – apart from excessive trading and innovations such as the never-ending expansion of derivatives – a meaningful part of real economy finance as well. At the same time, there is chaff in retail banking, about which many retail

¹ Abbreviation of road-safety test in Germany.

clients can tell us. This means that we have to sort out the chaff, in order to come to a workable and effective financial system.

The aim of the Liikanen-proposal is to reduce the probability and impact of banking failure, to better protect retail clients and to limit taxpayer liability for bailouts. Therefore the working group's key proposal is the legal separation of certain investment banking activities from deposit-taking within a banking group. The idea goes back to the US Glass-Steagall Act of 1933 and thus to a time, when the world of financial innovations was easier to oversee.

Today, even without the exceptions in the Liikanen-proposal, just separating the sectors would still allow systemic risk and shadow banking to flourish. More and more lending is done by hedge-funds. The IMF mentions the move of business to nonbank financial institutions, warns of the systemic risks caused by the rising importance of nonbank credit, and calls for simpler financial instruments (IMF, pp. 63, 75ff). However, the Liikanen-proposal is limited to banks.

In the USA, investment banks developed dynamically under the Glass-Steagall Act, which was in place till 1999. Lehman Brothers was a pure investment bank. Not only banks or financial institutions are systemically important. Systemical importance is mainly related to financial instruments, as will be shown in the following text.

2 Calling for a new simplicity

“As you do not fight fire with fire, you do not fight complexity with complexity. Because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity, not complexity.”

Haldane, p. 24

In statistics you learn that it is essential to differentiate between correlation and causality. So there might be a strong correlation of many babies and many storks in the same region, but no causality between them. Yet in securitisation–modelling causality is badly understood due to the immense over–complexity of many parameters.

Complexity increases opacity, while transparency is a precondition for supervision. The spread of complex financial innovations contributes to the growing shadow banking sector and its interconnections with banks as well as with insurance companies and investment funds. Complexity is also a driving force for derivatives and their excessive trading, because they deal with uncertainty. Hence complexity leads to more complexity.

As a result, regulatory documents have also become much longer and complex. The Basel III Accord for capital adequacy requirements exceeds 1,000 pages. In the USA the Dodd–Frank Act runs to 848 pages; the finalisation of the required rules will lead to about 30,000 pages – about thousand times longer than the Glass–Steagall Act (Haldane, p. 10f). At the same time, the Bank for International Settlements states that many of the data required for identifying international linkages, even at a rudimentary level, are not available. The institutional infrastructure for systemic risk management is inadequate or

simply non-existent (Cerutti, p. 1). The danger is even higher for developing countries, where financial innovations are encroaching due to capital market liberalisation.

However, the solution to over-complexity cannot solely be to simplify regulation.

Haldane, for example, focusses mainly on simpler rules like capital requirements without risk-weighting. Instead, the solution must be to tackle the complexity at the roots, which means at the level of financial innovations – by testing them before they are allowed to enter the market. This is vital in order to make macro-prudential supervision possible.

Otherwise, institutions for macro-prudential supervision like the European System of Financial Supervision (ESFS) or the Financial Stability Oversight Council (FSOC) in the USA are unable to operate effectively.

3 Distinguishing between useful and harmful innovations

“I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth.”

Paul Volcker (11/9/2009)

The effects of financial innovations lie both in their application and in their design. The same purpose can often be fulfilled by a variety of financial instruments, which can be more or less useful or harmful to the real economy and to society. The alternatives of collateralised debt obligations (CDO)² vis-à-vis simple covered bonds backed by real assets is a good example (Judge, p. 716f).

We do not need millions of different financial instruments. In investment strategies simplicity often outperforms complex strategies (Haldane, p. 6). Exchange-traded funds, for example, often deliver better returns than actively managed funds.

² CDO is to change whole credits via packaging and re-packaging into tradable securities (= securitisation and re-securitisation).

Purposes and driving forces of financial innovations:

– positive –

- ***Simplifying money transactions:*** Giro payments and debit cards are key instruments to facilitate transactions and reduce transaction costs.
- ***Financing businesses, consumer needs and states:*** The traditional purpose of finance is to facilitate the performance of the real economy. Financial innovations should provide debt and equity in the right balance and on a sustainable basis. These can include different kinds of bonds, stocks and mixed forms like mezzanine capital. For state finance, Eurobonds could be a useful innovation and strengthen democracy, because they would prohibit speculation against individual states.
- ***Creating true wealth:*** Money is transferred from areas of surplus to areas of demand and need through debt and equity finance. The traditional purpose of finance is to inject investors' wealth into the real economy, not gambling.

– negative –

- ***Avoiding regulation:*** One of the key drivers of financial innovation is the desire to overcome (the cost of) regulation. Thus, regulations are followed by innovations whose main purpose is to avoid the regulation (Allen, p. 42). By multi-layered securitisation, banks spread the risks from their balance sheets, in order to avoid the equity capital requirements demanded by the Basel Accord. The Liikanen-Report suggests structural reforms, including tightened capital requirements, which will be easily circumvented without a finance-TÜV. Financial innovations will try (and, based on historical evidence, soon succeed!) to weaken and cross the planned border between retail and investment banking. Without a preventive testing of financial instruments, regulation will always lag behind. The same is true with regard to internal risk management (IMF, p. 8).
- ***Avoiding taxes:*** A second key driver of financial innovation is tax avoidance. With some derivatives, for example, companies can shift profits to earlier or later time periods. The Liikanen-Report aims at limiting taxpayer liability for bank losses, but it does not tackle the massive tax avoidance carried out with the help of banks and financial institutions.
- ***Making money out of complexity:*** Complexity is generally more lucrative for financial institutions than simplicity, especially for rating agencies. Yet the price for regulators, supervisors and society is opacity. Securitisation can be useful up to

a point; savings banks, for example, use it to diversify their regional risks.

However, re-securitisation (securitisation squared, cubed etc.) is not needed by the real economy. It should be prohibited. Currently, it is still only bound by weak conditions such as higher equity capital requirements or the demand that banks have to hold a certain percentage on their own balance sheets. The Liikanen-Report proposes as an additional measure the improved pricing of risk as a bail-in instrument. However, we are facing here also a “too-complex-to price” problem of financial instruments.

- ***Making money out of money but harming the real economy:*** Financial investors now dominate the pricing of commodities like grain, rice and oil. The influence of financial markets has transformed these real markets into financial markets (UNCTAD). Financial investors, who have nothing to do with the real food business, deal with commodity assets such as food derivatives, which lead to price hikes and increased malnutrition.
- ***Staying competitive as margins decline quickly:*** There are usually no patents available for financial innovations, so they can easily be copied and profits decline quickly. This leads to competitive pressures and financial institutions constantly introducing new financial instruments.

– positive or negative –

- ***Dealing with financial risk:*** Risk sharing is a fundamental and useful component of finance. But risk transfer is not risk elimination. Individual risk transfer must not cause incalculable systemic risk: e.g. if derivative instruments like credit default swaps (CDS)³ or innovative debt securities like collateralised debt obligations (CDO) allow banks to spread their risks around capital markets. Another problem occurs where there is no fundamental underlying real business risk, but uncertainty due to other financial innovations. That is often the case with derivatives. To avoid this self-made risk, such innovations should be prohibited.

To conclude, the harmful nature of some financial innovations is not just a question of abuse and mistakes, but also of unintended systemic consequences. This can be avoided by prior testing. Negative effects of financial innovations are not confined to crisis periods; but are an everyday issue, as the examples of regulation avoidance and tax avoidance show. Even more, the increase in complex financial instruments has led to a decline in credit business and securities emissions (Dullien, p. 16), which means a complete misallocation of resources. This cannot be changed just by separating certain investment banking activities from deposit-taking banking.

³ CDS is to change credit risks like debt-servicing into tradable securities (= type of derivative).

4 Benefiting from financial testing

“Rapid innovation is often a harbinger of a crisis.”

Mullineux, p. 250

A precautionary principle for financial innovations affecting the whole economy should be as self-evident as it is for electrical products and drugs. Investment banking and wholesale innovations need to be stress tested as is done for systemically important banks.

Policies and criteria for financial testing:

- ***positive list:*** Financial institutions will have to prove that the financial instrument is beneficial to the real economy and (in case of alternatives) is the most welfare enhancing option. It must be proven that the financial instrument is not harmful and that the risk-reward-profile is positive. The name of financial innovations also matter: Structured financial instruments must no longer be called bonds.
- ***bound by conditions:*** Some financial innovations should be bound by specific conditions, e.g. position limits for certain derivatives and higher equity capital requirements for re-securitisation instruments.
- ***legally unenforceable or prohibited:*** Financial instruments not on the list would either be legally unenforceable or prohibited. In countries such as Austria, Germany, and Switzerland financial bets on future prices were earlier classified as

financial gambling and legally unenforceable. This was to protect retail clients against banks gambling with their money. This "financial gambling reservation" law was abolished due to pressures from the financial markets ten years ago.

As a key preventive and efficient measure at the base of financial regulation, financial testing would facilitate and simplify new regulations; the risk of institutions "too complex to be supervised", "too complex to be managed" or "too connected to fail" would be reduced. Effective market supervision of financial innovations would become possible.

Fewer financial instruments and more highly qualified and paid regulators and supervisors are necessary. Many decisions on which instruments to allow will be controversial. It will therefore be important to build a mixed regulatory committee with representation from the real economy, trade unions and consumer organisations.

These are some of the questions to be decided by regulators:

- According to what criteria shall financial innovations be classified?
- What is the distinction between a new financial instrument and the adaption of an existing one?
- Is a process innovation like a new technique (e.g. a pricing mechanism) already new financial instruments?
- When is the combination of financial instruments a financial innovation?

- Shall non-standardised over-the-counter contracts still be allowed for customised solutions – and if so, to which extent?
- What do stress tests look like for financial innovations?
- Which decisions are to be taken at the global level, and which can be left to national or regional administrations?

Financial testing has been suggested by economists such as Joseph Stiglitz, Ha-Joon Chang and Sebastian Dullien as well as by parliamentarians, the social movement attac, trade unions and consumer organisations. The Bank for International Settlements already proposed a finance-TÜV – as a “poisons list” – when the Group of 20 negotiated about key measures for financial market regulation 2009 in Pittsburgh. The discussion of financial instruments testing is often confined to retail issues such as investor protection and safety, excluding broader issues of regulation and taxes. A concept of financial innovation testing needs to be developed and implemented. An immediate initiative by the European Commission on this issue would be extremely well-received.

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Contact

Suleika Reiners

Policy Officer Future Finance
World Future Council, Head Office
Mexikoring 29
22297 Hamburg
Tel: +49-40 3070914 25
Fax: +49-40 3070914 14
E-mail: Suleika.Reiners@worldfuturecouncil.org

Jakob von Uexkull

Founder
Chairman, Management Board
World Future Council
100 Pall Mall, London, SW1Y 5NQ, UK
Tel: +44-20 7321 3812
Fax: +44-20 7321 3738
www.worldfuturecouncil.org