Griffith UNIVERSITY

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OUTCOME PAPERS
Financial Integrity

Towards an Integrity 20

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FINANCIAL INTEGRITY

OVERVIEW

In 2008–9, it was widely recognised that ethical failures were a significant part of the problems that created the Global Financial Crisis (GFC) or the “Great Recession” as it is referred to outside of Australia. The same proved true of more recent financial scandals (such as the LIBOR scandal and currency manipulation). It should not be surprising that improvements in the ethics and integrity of key players would be an important part of the solution.
Ethical standard setting can work to reinforce regulation and institutional reform to reduce the risks of future crises and to ensure that financial systems benefit the societies in which they operate by ensuring the efficient and effective flow of capital, with limited transactions costs, to where it can be used more effectively.

WHAT WENT WRONG? WHAY WAS IT WE GOT SO CLOSE TO THE BRINK?

The GFC had an array of causes. Some of the major causes clearly involved integrity failures. These occurred within banks and bankers, motivated by bonuses for fees and profits secured, and pursuing rewards by transferring risks to consumers and to the global system itself. Integrity failures also occurred within ratings agencies, with conflicting interests in remuneration leading to high ratings given to very risky instruments. Volker suggests the regulatory structure is no longer fit for purpose and many thank the repeal of the Glass–Steagall Act was a major mistake.

WHY ARE THERE ONGOING PROBLEMS

Has there been regulatory capture of banking regulation? (Or ‘deregulatory’ capture?)

- All the solutions seem to involve providing more money to banks even when they seem to be a large part of the problem. Do we rely too much on advice from banks?
- Banks have greater knowledge and greater interest in certain outcomes. We can have a general belief in the efficacy of markets. But if the players are all seen to be self-interested profit maximisers (economic man) does this mean that their proposals will all be in their self-interest?
- We should make a distinction between advice and salesmanship. Banks do not seem to have fully understood this in dealing with their clients. (from American movers of toxic products in 2008-9 to recent financial advice scandals in Australia). Do banks understand the difference between policy advice and salesmanship to governments?
- Should banks policy advice be public and treated as a statement to the market, subject to the strict enforcement of mis-statements to market?
- In any case, governments should recognise that banks have an interest in us following policy that suits them. This does not mean that banks should be ignored. But it means that their policy analysis, advice and recommendations should be subject to intense public scrutiny. Those whose advice is more than ideology and self-interest should be given more attention. And the search for knowledgeable and disinterested advice must be all the greater.

Is banking too large a part of our economy? It has risen from 4% to 8% of US GDP over the last 50 years.

- Does that mean a more important role, less efficient or a successful rent extractor?
- What would we say if lawyers’ income as a percentage of GDP doubled? Would you assume that you had twice as much justice? And is the US healthier for spending almost twice as much of its GDP on health than comparable countries?
- Might we have the same attitude to the US banking system as we do for its legal and health systems? This is not to deny the brilliance, skills and achievements of many American lawyers and doctors. But the legal and health systems are not global exemplars for cost and effectiveness. Should G20 governments (including the US) look elsewhere? Should the debate start with the merits and problems of each.
- Post GFC, is banking too concentrated?

Should banking involve low risk, lower return? If not, why not?

- Banking involves lending on security. The bank gets paid out of its security first. All share capital is lost before the bank loses anything. If the risk to a company that borrows is greater, and the risk to the bank is less, and if markets operate in the way they are supposed to operate, bank return on capital ought to be less. If not, the bank is either engaging in risky behaviour or oligopolist rent seeking – or both.
- Should bankers be rewarded for risk taking (whether the risks are on the banks, their customers or the economy)? We do not want lawyers, doctors and engineers to take big risks – indeed we expect high standards of care and disbarment for negligence. Should we expect the same of banks/bankers?

Is there a 'democratic deficit'?

- Polls show widespread dissatisfaction amongst democratic populations about the behaviour of financial operators. Yet legislators have proven resistant to pursuing regulation, as much as executive have proven timid in pursuing prosecutions. This disconnect between the will of the people and the behaviour of their elected representatives impacts worryingly upon the perceived legitimacy of current liberal democracies with the G20 countries.

Why are there not more victims of the GFC among bankers?

- Governments lent banks extra money in an emergency. Governments did not take the same approach to indigent banks that banks take with their debtors.
- hould even stronger action have been taken? In contexts of professional responsibility, self-serving recklessness can be a criminal offence. If CEOs were not 'too big to jail', then public confidence and improved deterrence might have been consolidated.

Why are there not more discredited economists?

Why did we not learn the lessons from Long Term Capital Management and the Asian crisis?

A lack of consensus

- The importance of international consensus on integrity issues in finance cannot be underestimated. Member states should seek agreement on exactly what ethical failures—committed by which institutional role-holders—played a role in causing the Global Financial Crisis. In the twenty-first century, what ethical expectations do we have for market actors? Is honesty enough—or in some contexts must we demand a professional fiduciary obligation and sense of fairness? Achieving explicit agreement on what constitutes blameworthy behaviour would help frame future expectations.
- In the immediate aftermath of a financial crisis, consensus is easier to achieve. But implementing integrity reform and regulation is a painstaking and meticulous task, requiring commitment and vigilance over a long period. Entrenching integrity has substantial costs in time, resources and political will and cannot be abandoned at the next economic upturn.
- Have we 'wasted the crisis' and/or has crisis become the 'new normal', so looming crisis produces a muted response.

For those who did not significantly suffer, what did they do right?

Australia enjoyed clear benefits – terms of trade, very low debt going into the GFC and some precautionary interest rate rises because of a concern that a property bubble was emerging. But it did share risks – banks very heavily reliant on household lending and recent bi-partisan reduction in individual income taxation. Australia had learned from recent experience of corporate failures and near misses of the 1990s. However, the centre of its policy was different from other approaches – reflecting what would be called a 'Main Street not Wall Street' approach. Money was given to citizens not banks. Housing activities and values were propped up with extended new home grants. There was also a gradated series of capital initiatives from small scale (insulation) to medium (school halls etc.) and then larger scale infrastructure developments. There are debates about which actions should have been chosen, whether more than usual was wasted or whether there was adequate risk management. But the big question for G20 governments to consider individually and collectively are the relative merits of providing support for banks and their customers and the mixture of those measures to be adopted. If economic activity is weak, banks may be very cautious about lending to businesses to expand output and employment.

WHAT SHOULD BE DONE?

Vetting of financial instruments?

- CDOs were based on a contract written by a New York lawyer. When trillions dollars of CDOs were issued, the lawyer hoped that, when they eventually got to court, the judges would 'get their decisions right'.
- Should there be restriction on new instruments (e.g. no more than $1bn of any instrument sold before it is formally approved)? Or can this could be done through capital adequacy provisions?

Increased capitalisation of IMF (and/or regional banks/new banks)?

- The current proposal is for the IMF to be given increased capital by the members whose economies have been growing in recent years. This would alter the voting powers on IMF decisions – though not radically. Other proposals involve strengthening regional banks or a new 'BRICS' bank.

Change the role of banks?

- Should governments have a greater role in credit creation? Credit is generally created by banks with interest rates the major, publicly ordained constraint on how much credit is created. Credit creation used to be regulated by central banks, directing how much credit could be created through new loans and which sectors should receive it (which were ultimately under government control).

Reduce moral hazard of TBTF (too big to fail)?

- Should we aim to ensure that directors, managers and shareholders suffer the consequences of bad decisions without destroying the financial system? This would involve preserving the system at the expense of the bank rather than preserving the bank at the expense of the system.
- There are many suggestions. One, by Gjerstad and Smith in the Wall St Journal suggests issuing a class of bonds for 8% of assets that would give their bond holders rights to take over banks and equity, and boards would be wiped out – emphasising that no banker is too big to lose their job and no bank too big to lose all equity. This suggestion leads to a further thought about different risks for different returns – with government capital coming in after everything else is lost.

Ratings agencies – should there be a change in ethics, remuneration, or ownership?

- Should we be surprised that they are still around? Is it surprising that creditor nations would have not set up their own ratings agencies?

Professionalization of Banking and Finance? (see separate paper)

- Professionalization is not the whole answer but an important part of the answer. The role of the professions in building governance is not widely appreciated, and can be missed in top-down decisions from government, and grass-roots campaigns from citizens. Instead, initiatives focused at the crucial middle-levels of professionals can add a crucial piece of the integrity puzzle

Taking back the privileges

- Societies offer specific privileges, especially legal and financial privileges, to certain organizations and practitioners in order for them to fulfil socially useful functions. In finance, communities offer limited liability to corporations, and recently dissolved the structure separation between traditional and investment banking. These entitlements must be recognized as privileges, not rights. Societies can and should withdraw these privileges if those enjoying them cannot use them responsibly.

WHO SHOULD BE INVOLVED?

Role of banks?

Should bankers identify what some of their members did wrong and how standards should be improved instead resisting proposals from governments and gaming regulation? This recognises that governance reform needs to be bottom up as well as top down with banks playing their part in a multi-level regulatory regime. It recognises that governance needs to be ethical and institutional as well as regulatory and governmental. Financial institutions need to build their risk management, ethics, culture and professionalism.

Role of bank customers?
Should we include the B20 (not including banks), small business groups and regional communities, consumer protection authorities?

Role of bank shareholders?
Should shareholders be demanding that banks do not take these risks with their money?

Role of creditors – and creditor nations.

Role of professions
Including lawyers who wrote CDOs, accountants preparing accounts, and auditors who signed off.

WHO SHOULD DECIDE?

The B20 wants finalisation of core global financial reforms in 2014 and to establish a protocol for international rule making processes commencing in 2015 which better engages the private sector to ensure rules are fit for purpose and take account of their impact on the real economy. This is now a global governance issue (or more strictly, a multi-level governance issue). The strongest regulation at national level but agreement and co-ordination at international level is critical. How will that co-ordination be achieved?

Multilateral
There are already a number of UN bodies (IMF, World Bank, ECOSOC (economic equivalent of the UNSC)? Is G20 a surrogate for the above? Or should we see G20 and UN bodies in a dynamic relationship with the G20 as norm generator and UN as norm legitimator?

Bilateral (presumably a smaller role – though US and China might sensibly identify common ground)
However, dispute resolution is bilateral: international arbitration, ISDS or ICJ?

Unilateral
The USA might want global finance to be governed by their laws and institutions (e.g. extra territorial regulation and taxation, the Greise decision on Argentina, fines on UK banks). Others may be less comfortable doing so. The GFC and sub-prime mean that there is reduced trust in the US to run it by themselves – and there may be growing concerns that such regulations may be imposed to serve the interests of the US. Note attempts by Argentina to take the matter to the ICJ – should all matters of international finance (and tax) be referable to a supra-national court. The ECJ is getting involved, for example, in freezing of the accounts of those suspected of terrorism without adequate opportunities to challenge the decision.
All foreign banks operating there to become subsidiary companies, and requiring international banks with US-dollar clearing accounts to comply fully with US tax, regulatory, and even, to some degree, foreign policy (for example, refraining from trading with US enemies).
Hefty fines imposed by US regulators for breaching the rules (e.g. 8.9 bn settlement with BNP Paribas is already causing European banks to re-think their compliance costs and the profitability of operating in the US). Imposition of US sanctions via US banks. This action might drive banks out of US or at least establish alternative arrangements such as a new development bank and contingent reserve arrangement by the BRICS countries.

WHAT SHOULD THE G20 DO?

1. The Brisbane leaders' declaration could re-emphasise the integrity dimensions of the problems and solutions in global finance.
2. The finance working group should ensure that it has widespread input from those not associated with the banking sector. Where proposals come from financial institutions or those associated with them, the working group should require full disclosure of the expected benefits to the banking sector of any reforms they propose (or existing arrangements whose reforms they oppose).
3. The finance working group should include consideration of the potential ongoing problems listed above and consider the suggestions for what might be done.
4. The GIS urges the G20 to recognize the capacity and responsibility of existing professions, especially lawyers and accountants to improve governance. The development of a finance profession should be encouraged provided it follows the pattern of the above professions.

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