

Setting the scene: financialism as a single story.¹⁾

Introduction

Chimamanda Adichie is an exceptional Nigerian author. In a speech at the TED conferences in 2009 she said:

"Power is the ability not just to tell the story of another person, but to make it the definitive story of that person.

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"The 'single story' creates stereotypes, and the problem with stereotypes is not that they are untrue but that they are incomplete. They make one story become the only story."

The 'story' of the financial and economic crisis of 2007-2008 still holds us in thrall. The information pack for this seminar states that economists, political scientists, sociologists, psychologists, philosophers, anthropologists and biochemists have studied the causes of the crisis.

It derides lawyers for being remarkably quiet on this subject.

The question is whether legal rules are lacking, whether they have not been properly applied, or even whether they have helped to trigger or exacerbate the crisis.

Perhaps the lawyers have been quiet because they still do not have a full picture of the multiplicity of factors which contributed to the crisis. In this introduction I would like to explain my view of these circumstances, which is based on my own experience in a supervisory capacity, though it only reflects my personal conviction.

1. The origin of the financial crisis

In the past five years numerous experts in a number of countries have conducted many technical studies. In Britain, Lord Adair Turner produced a particularly clear report known as the Turner Review.

a. *The Turner Review*

Our system is based on the concept of a 'free market economy', with companies subject to rules laid down primarily in competition law, but subsequently also in financial law.

Over the past twenty years, the following theory – the story – regarding the financial markets has been unchallenged²):

"But the predominant tendency of financial markets theory of the last 20 to 30 years has been to assert that:

(i) efficient and liquid financial markets deliver major allocative efficiency benefits by making possible a full range of contracts, thus enabling providers and users of funds more effectively to meet their preferences for risk, return and liquidity;

(ii) markets are sufficiently rational as to justify a strong presumption in favour of market deregulation; and

(iii) that even if markets are theoretically capable of irrational behaviour, policymakers will never be able to judge when and how far they are irrational with sufficient confidence to justify market intervention."

In the face of these principles, this 'story', the regulators developed a system which they believed would generate a deep, liquid capital market, accompanied by a legal framework which only needed to organise sufficient adherence to commitments and respect for property, a framework that only needed to counteract fraud. In line with these ideas, the regulators had a role to play specifically in organising the exchange of information, where the aim is to ensure that all investors gain access to comparable information simultaneously.

The Turner Review finds that these three fundamental principles proved erroneous.

So the question is: how have we reached this point? Does it demonstrate the failure of capitalism as a system?

b. *Capitalism is evolving*

There are many definitions of capitalism, described in many disciplines and countless studies.

To simplify the argument, I only want to refer to a timeline that most people are familiar with. When capitalism began, family businesses predominated, but development led to larger enterprises needing proper management.

However, managerial capitalism fairly rapidly gave way to investment capitalism.

In a family business, the directors and the management still had an overall view of all the work processes in the business, but industrialisation created a need to enlist competent outsiders who were then appointed first as managers and later as directors of corporate structures.

But it did not stop there.

Very soon, the need for investment funding led to the development of investment capitalism, with all the corresponding rules.

The successive amendments to our corporate legislation bear witness to these changes.

However, the past two decades brought a new phase in which investment capitalism developed into what we might call 'financial capitalism', or even 'financialism', with corporate objectives and working methods which are fundamentally different from those of yesteryear.

Until the investment capitalism stage, the operation of the investee business and its importance in the real economy were the criteria for assessing the decisions taken, but with the advent of financial capitalism, the concept of 'shareholder value' became predominant, and the link with the real economy was actually severed. This development is referred to as 'financialism'.

c. *Brief account of financialism*

"Financialism is an economic system where the primary activity consists of creating and manipulating financial instruments. Financial instruments - loans, mortgages, stocks, bonds, so on - are in their original form firmly linked to economic reality: the mortgage finances home ownership, the stock certificate represents ownership of a company that owns physical assets, the bond secures debt incurred to build a factory.

However, when financialism sets in, financial instruments become progressively further removed from their role in supporting commerce in the real world and develop a life of their own, a weird shadow dimension, a hall of mirrors, a distorted alternate reality that intersects and reacts with the real economy in unpredictable and destructive ways. George Soros described this phenomenon as "reflexivity". Derivatives have a lot to do with it. Leverage and the abuse of easy credit are contributing causes. The shadow banking system is a symptom"³).

Financialism originates from tools belonging to at least four disciplines which fall within the broad scope of this seminar:

1. In economics a very strong tendency has emerged, culminating in statements by the Nobel Prize winner Milton Friedman, who said that the only aim of a business must be to generate profits⁴).

This is seen as its sole corporate function to which all other aims are subordinate.

2. In the technological development of resources that support the running of a business, mathematical models now make it possible to offer not only figures giving an idea of the value of a business, but also an increasingly accurate – or at least convincing - prediction of how those figures will change in the future.

3. In accounting, there has been a fundamental change from historical accounting to risk-driven assessment, and to the practice of discounting future figures on the observation date, whereby the figures already take account of future developments. Consequently, far less importance is attached to the real economic context of the business and its continuing usefulness to society. Instead, what counts

is the value gained on paper: although that gain has not yet actually been achieved, it is apparent in the discounted figures and can then be cashed in as quickly as possible by shareholders selling the shares in a liquid market. The seller no longer cares whether the built-in future increase in value can or will ever be realised.

4. From the managerial point of view these developments emerged first in the United States. They were reflected there in the way in which market regulation developed and in the method of organising the governance structures of businesses. The concept in which directors and managers took on personal responsibility for the survival and development of the business in which they worked gave way to a regime in which directors and managers are seen as purely carrying out the policy decisions of the shareholders. Here it should be borne in mind that the shareholders have only one aim in view, namely to make a profit as quickly as possible, with all the associated volatility for their shareholdership itself.

In the United States this led to techniques in which managers, partly for selfpreservation, did their utmost to drive up the financial results of the business.

They actually ceased to focus on their company's core business (e.g. Enron) but tried to maximise the financial income that the business can vaunt, and the return that it can offer its shareholders.

For that purpose they used numerous leverage techniques, which produced excellent results on paper but would ultimately undermine the business.

An institutional answer actually emerged in the degree to which their legal relationship with one another and with the shareholders could still prompt the management and directors to be cautious about the shareholders' objectives. Whereas, a few decades ago, traditional institutional investors such as bankers and insurers invested in industrial companies with industrial development potential, the nature of institutional shareholders has changed. Private equity funds, hedge funds, and even pension funds have become major shareholders, thus gaining that power in the business. And from the moment that they can exercise power, maximising shareholder value means that all sorts of techniques are introduced into the day-to-day management: the company's debt ratio is increased to its maximum in

the short term, the intrinsic capital of the business is cut where possible, and operational activities are reorganised to generate the maximum rapid sale value.

This leads to a sort of managerial Ponzi scheme in which the eventual owner of the property rights will be left with a virtually worthless business that will go bankrupt.

The same techniques were transposed to the financial sector.

Schemes which were originally devised to cover risks were gradually separated from their economic reality.

A CDS became a naked CDS, and therefore an instrument for gambling. The same economic risk could be covered by multiple CDSs, because there was good money to be made as soon as the default event occurred.

Moral hazard became an integral part of the financial devices.

But this technique enhances the shareholder value at a time when the settlement date is not yet in sight, and so long as disposal is still possible because of the Ponzi effect, based on deep liquidity.

These structures became even more complex in CDSs-squared, which were so complicated that even an experienced financier could no longer understand how they would ultimately be settled.

But so long as there were buyers, there was a lot of money to be made, and it was assumed that the developers would not be blamed. In fact, most of these transactions took place between professional contracting parties who were therefore assumed to know just how risky these investments were.

In addition, no account was taken of a number of macro-economic effects, such as the reduction in property values and - in an environment where credit had expanded inordinately owing to its leverage in relation to the real economy - events such as the crisis of confidence triggered by the subprime incident.

d. *Description of the danger in the financial sector*

As explained above, both the new accounting rules and the development of mathematical models enabled financial institutions to inflate their figures.

1. The mechanics of accountability

The Turner Review⁵⁾ demonstrates particularly clearly how the regulations allowed uncontrolled credit expansion, thereby endangering financial institutions:

"Most of the holdings of the securitised credit and the vast majority of the losses which arose, were not in the books of end investors intending to hold the assets to maturity, but on the books of highly leveraged banks and bank-like institutions.

This reflected an evolution of the securitised credit model away from the initial descriptions. To an increasing extent, credit securitised and taken off one bank's balance sheet, was not simply sold through to an end investor, but:

- bought by the propriety trading desk of another bank; and/or
- sold by the first bank but with part of the risk retained via the use of credit derivatives; and/or
- 'resecuritised' into increasingly complex and opaque instruments (e.g. CDOs and CDO-squareds); and/or
- used as collateral to raise short-term liquidity.

In total, this created a complex chain of multiple relationships between multiple institutions, each performing a different small slice of the credit intermediation and maturity transformation process, and each with a leveraged balance sheet requiring a small slice of capital to support that function.

Some banks were truly doing 'originate and distribute', but the trading operations of other banks (and sometimes of the same bank) were doing 'acquire and arbitrage'. The new model left most of the risk still somewhere on the balance sheets of banks and bank-like institutions but in a much more complex and less transparent fashion.

Five key features of this new model played a crucial role in increasing systemic risks, contributing to the credit boom in the upswing and exacerbating the self-reinforcing nature of the subsequent downswing:

- (i) The growth of the financial sector.
- (ii) Increasing leverage - in many forms.
- (iii) Changing forms of maturity transformation.
- (iv) A misplaced reliance on sophisticated maths.
- (v) Hard-wired procyclicality."

2. An example of reinforcing factors

In a particularly interesting paper on whether the regulation of the method of remunerating managers increases the inclination to take decisions which are risky for the company, W. Lazonick⁶⁾ concludes that giving stock options encourages managers to artificially enhance the value of the business at the time of exercising those options.

In some circumstances this appears to be a 'weapon of value destruction' , as is the purchase of own shares, rather than a measure to inhibit the taking of risks detrimental to the company.

3. Why the blind faith in financialism?

The technical causes of the crisis are gradually becoming clear. The practice of financialism spread in the context of economic convictions about shareholder value, propagated partly by Milton Friedman. This development was also eagerly accepted and promoted by the American government, which proceeded with extensive financial deregulation. At a time when the population faced a rising toll of body-bags following the attack on Iraq, the relaxation of the rules on credit was helpful in maintaining the impression of increasing prosperity. Until the bubble burst.

2. Globalisation of the crisis

These developments took place in the American context and more generally in the Anglo-Saxon context, but inevitably spread to Europe.

The international scale and operation of financial institutions is one of the key factors here, but the main factor is the globalisation of the type of practices adopted by financial institutions, regardless of their size, and the volatility and mobility of their managers in a 'globalised' context.

As a result of globalisation, practices common in the United States and the United Kingdom generated substantially bigger profits than the more traditional practices in other economic regions; as soon as that happened, it was more or less inevitable that those practices would become prevalent everywhere. The training of people destined to take on management functions in financial institutions also centred on the new dominant 'story' of financialism.

Technically, securitisation and the sale of claims packaged accordingly was a way of reducing the balance sheets of US banks, increasing revenue leverage, and flooding the European financial market with instruments which – moreover - appeared to be very creditworthy in view of the rating agencies' opinions.

All this was further reinforced by globally active businesses recruiting management and directors specifically trained in the Anglo-Saxon context, who therefore saw no problem at all in introducing practices that they considered totally justifiable.

If young managers are trained for a couple of decades in the conviction that the market forces regime - in which deregulation is the key word - and free self-regulation provide the best conditions for the development of a prosperous society, then they can hardly be expected not to support that view if they are also offered attractive remuneration for perpetuating this system.

In many businesses, these developments took place in good faith; a number of market players refined these techniques to their current utmost limit in the pursuit of profit.

We must be aware of that.

In their contribution to the book "The Embedded Firm", F. J. De Graaf and C. A. Williams⁷⁾ quote Alan Greenspan who, in October 2008, told the United States

House Committee on Oversight and Government Reform: "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", and judge Richard Posner, one of the founders of the "Law and the Economics" movement since the 1970s, who said: "Some conservatives believe that the depression is the result of unwise government policies. I believe it is a market failure. The government's myopia, passivity and blunders played a critical role in allowing the recession to balloon into a depression, and so have several fortuitous factors. But without any government regulation of the financial industry the economy would still, in all likelihood, be in a depression. We are learning from it that we need a more active and intelligent government to keep our model of capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience - the self-healing powers - of laissez-faire capitalism."

The dominance of the shareholder is expressed most clearly in a takeover.

The arduous struggle for successful introduction of the takeovers directive, owing to the differences of approach between the Anglo-Saxons and the more continental legal systems, resulted in a regime that offers multiple interpretations.

The Winter Report⁸⁾ stressed that the shareholders' right to take the ultimate decision on whether or not to accept the takeover bid and the price offered, as expressed in recital 16 to the EU takeovers directive, reflects the Anglo-Saxon shareholder value approach.

However, the shareholders' dominance over the company is nowadays being called into question.

In the European context, the division of power between the various stakeholders in a company has been the focus of special attention, yet in reality the shareholder has increasing power.

Only recently, in analysing the departure of Duco Sickinghe, journalists writing in *De Tijd*⁹⁾ commented:

"He managed to make Telenet profitable. In addition, the weakened share became so cheap that opportunistic investors gradually returned. After a year, the share was already trading at a good profit. And things only got better. In 2007, Liberty Global upped its stake from 28 % to just under 50 %. From then on the Liberty approach prevailed: take on debts and reduce the capital at the same time. And at the same time make a profit. In 2008, the company's cashflow margin topped the giddy heights of 50 % for the first time. In 2008, Sickinghe – who by now had become an excellent investors' masseur – announced that Telenet planned to continue rewarding loyal shareholders year after year in a tax-efficient way. Shareholders became the favourite stakeholders in the Telenet strategy. There were no major takeovers involved, even though rumours emerged over the years, e.g. about tying the knot with Mobistar. "Telenet prefers to bid for itself", read the headline in De Tijd in 2012.

Another headline, dating from 2010: 'The shareholder's benefactor.' That shareholder was Liberty Media, which was getting shares for nothing thanks to the constantly increasing leverage. The small shareholders were in it together with Liberty, and they benefited too. Will they continue to do so after the Duco era? The Liberty strategy cannot last for ever. Telenet still has precious little capital and mounting debts."

That is a textbook example of the developments just described, albeit in industry rather than in the financial sector.

3. What should be done?

What should the lawyers do?

In the short term, technical measures are possible, but more fundamental thinking is also required. So lawyers need to do think about both cyclical and structural aspects.

a. Primary research: cyclical technical survey

In order to work out what measures to adopt, we first need to take a helicopter view in which lawyers re-examine the rules on how managers, directors and shareholders should deal with one another.

Supervisors are working to tighten up both the financial rules, in terms of a whole series of ratios, and the corporate governance issues.

The big question is whether compliance with those ratios justifiably instils confidence. According to the ratios, the Belgian Dexia group was perfectly solvent when it slid into the abyss.

The measures which national supervisory authorities are taking in that area are based on the rules of European bodies (the ESAs, European Supervision Authorities: EBA, EIOPA, ESMA) and international organisations (Basel Committee, IAIS, IOSCO).

In practice, those rules are greatly influenced by the largest market players, who in this case are from the Anglo-Saxon world; their idea of a politically correct economy is thus being imposed on the rest of the world which is passively accepting their idea.

Their views therefore influence the way in which the texts should be worded and how they are adapted to the non Anglo-Saxon context.

This means that the training of lawyers, economists and commercial engineers should give them a thorough insight into the broader social context leading to the prevailing rules, so that they realise how rules which are inappropriate to their own cultural approach should be understood and interpreted by managers and directors, and their client/shareholders.

In the organisation of the economy, lawyers are usually only involved in the final stage, in devising the legislation. However, their contribution must not be confined to just transposing concepts developed by economists, statisticians and actuaries on the basis of pure technical efficiency. Quite apart from the fact that those other professions are also subject to a public consultation obligation.

The added value that lawyers can offer lies undoubtedly in their sensitivity to the changing interpretations that may be applied to a particular rule in the future.

Trained mathematicians sometimes tend to assume that they offer a solution which, once agreed, will create stability.

Heisenberg's principle whereby the observed object is influenced by the observer applies here.

In the financial sphere, all financial regulation will be digested after a time by the market players, and will therefore influence their behaviour in a way that is not obviously predictable.

That point needs to be borne in mind when the rules are being devised.

The rules therefore need to undergo constant critical scrutiny.

Another question here is whether broad concepts such as "public policy" can be used in that process and in the application of the rules by the courts.

Until recently, the concept of public policy in the financial sphere was very difficult to define.

That is undoubtedly still the case, but certain contours are beginning to emerge in the regulatory practice of supervisors.

The two elements given prominence by the regulators at international level are the maintenance of financial stability and the emphasis on inter-generational responsibility, to which should be added intra-generational responsibility, or in other words solidarity.

When issuing and applying financial regulations, lawyers will therefore have to understand and express how and when the maintenance of financial stability will affect relations between market players.

International organisations are trying to define this concept in more detail; it is a concept that is viewed mainly from a macro-economic angle.

The macro-economy then influences what can be classed as proper behaviour and honourable practice in the financial sphere.

Inter- and intra-generational responsibility is a concept that is much trickier to define, and essentially concerns the very heart of our social structures, such as new approaches to the solidarity obligation, e.g. in the context of the family.

There is no doubt that the turn of the century prompted some fundamental thinking on this subject.

Hayek said that once a particular level of social development has been reached, there is no going back.

That is the challenge facing the financial sector.

Having seen how capitalism was an engine of progress in the industrial sphere, do we want to continue to accept that the principles of competitiveness, growth and profit allocation in the financial sphere can be regulated according to exactly the same model as in the industrial world?

The crisis that has now dragged on for five years shows that the rules on the subject need to be reviewed or at least refined.

Financiers provide a service for the real community, and thus perform a public service. In assessing the proper behaviour of stakeholders in financial institutions, the interests of one stakeholder, more specifically the shareholder and his desire for value, must not be allowed to prevail over the interests of the other stakeholders, and of society as a whole.

Cyberspace has made it possible to develop virtual worlds such as Second Life.

Nevertheless, few will doubt that, while these virtual worlds allow extravagant fantasies within their own limits, that must not have a detrimental effect on the real world.

The same applies to developments in the financial world.

Financing techniques have become opaque and have grown inordinately, obscuring their character as a useful tool.

This requires a response, e.g. institutionally, by revising the structure of financial institutions (but there is little consensus on that, and a lot of lobbying) or, for example, by restricting certain types of activity (such as naked trading).

Be that as it may, the financial world also needs a multidisciplinary appraisal - that is including by the lawyers among us – bearing in mind that it should aim at a service-oriented architecture¹⁰).

b. *Secondary research: structural, fundamental survey*

Hector Sants, CEO of the British Financial Services Authority, talking about the requirements that will have to be imposed on financial institutions, said "*There must be clear recognition of the need for institutions to contribute to the common good*".¹¹)

Legally, the question is therefore whether the common good, to which Sants refers, can be defined in terms of 'public policy' or in terms of other more specific legal concepts in the regulations.

But the question goes beyond that.

The crisis started as an economic and technical problem caused by granting credit without adequate links to the real economy, and thus without security in the form of hard economic assets, but it then developed into a monetary crisis. The trigger was creditors' lack of confidence in the ability of sovereign states to fulfil the guarantees that they had offered concerning support for the financial sector. This crisis centred on the European Union, and more particularly Euroland.

It was exacerbated by the lack of united, appropriate responses by the political structure that Europe has become to the events exported to the European Union by a politically stronger entity, namely the US.

Politicians try to devise answers to the world order under the direction of the G20. However, the question is whether those answers are good enough to cope with the more fundamental problems that will increase the pressure on large parts of the financial system. The issues here are population ageing and the cost associated with mounting environmental problems, not to mention the imbalances which ensue as emerging countries strive for the same comfortable lifestyle as the now declining

developed economies, and not to mention the fact that, in their efforts to control the crisis, the authorities constantly turn to quantitative solutions (increasing solvency requirements for financial institutions), thereby overlooking the fundamental question whether these quantitative obligations are actually enough to make the system robust.

It is noticeable that some are already reducing the pursuit of the "common good" to the slightly modified continuation of the current system, without asking whether civil society will tolerate further hitches, some of which are already on the horizon.

On the other hand, it is argued that the current crisis is far more significant than previous ones. Some observers¹²⁾ think that the crisis represents a social revolution just as great as the change from an agricultural to an industrial society. The reason is the unprecedentedly marked global character of financialism, which means that there is no single traditional nation - or even a regional authority - that can adequately counteract the effects of this financialism¹³⁾.

What about the future?

Either the politicians will carry on patching up the system until it breaks, or they will conduct a new, fundamental inquiry into the universal rights that people nowadays can expect to enjoy in the face of the actual threats hanging over us (ageing, environment).

The globalisation of the quest for short-term profits can be countered by global promotion of the fundamental rights to which everyone is entitled in the financial sphere.

In legal terms, this means extending the range of human rights in addition to the existing socio-economic rights which pre-date financialism, taking particular care to ensure that these fundamental rights are actually enforceable by law. That is a challenge for politicians and lawyers. I hope it is not Utopian.

We can be sure that the world will soon look very different from today's world. The established certainties about financial, monetary and fiscal law and their

interconnections no longer exist. Their story has to be rewritten in the light of the experiences of the past five years.

The younger generations are entitled to a future which they can view with confidence. That is the foundation that will enable them to contribute useful innovations to our society.

To conclude with the words of Chimamanda Adichie, this symposium is just one story line. Not the only one. Not the definitive one. Which is just as well.

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- 1) MICHEL FLAMÉE, former Vice-Chairman of the CBFA, Belgian Financial Supervisory Authority - former Chair of the IAIS, International Association of Insurance Supervisors.
- 2) *The Turner Review*, FSA, p. 40, http://www.fsa.gov.uk/pubs/other/turner_review.pdf.
- 3) *Jungle Ethics Financialism vs. Free Market Capitalism*, TOM ARMISTEAD, June 8, 2009, <http://seekingalpha.com/article/141852-jungle-ethics-financialism-vs-free-market-capitalism>.
- 4) The views of Milton Friedman and their implications are discussed in detail in a study by LEO E. STRINE JR.: "*Human Freedom And Two Friedmen: Musings On The Implications Of Globalization For The Effective Regulation of Corporate Behavior*" (2007). Scholarship at Penn Law. Paper 187. http://lsr.nellco.org/upenn_wps/187/.
- 5) *The Turner Review*, p. 16, http://www.fsa.gov.uk/pubs/other/turner_review.pdf.
- 6) Why executive pay matters to innovation and inequality, in "*The Embedded Firm*", ED. C.A. WILLIAMS AND P. ZUMBANSEN, Cambridge University Press, p. 413-439.
- 7) The Intellectual foundations of the global financial crisis: analyses and proposals for reform, in "*The Embedded Firm*", ED. C.A. WILLIAMS AND P. ZUMBANSEN, Cambridge University Press, p. 392-393.
- 8) For an interesting American analysis of the EU Takeovers Directive, see: *The EU Takeovers Directive: a shareholder or stakeholder model?* in "*The Embedded Firm*", ED. C.A. WILLIAMS AND P. ZUMBANSEN, Cambridge University Press, p. 233-255.
- 9) De Tijd, Saturday, 9 March 2013.
- 10) Under the aegis of the VUB, KOEN BYTTEBIER and MICHEL FLAMÉE created the Chair of 'Stewardship of Finance' which is addressing this challenge, with our colleague PAUL JORION as the first incumbent, taking a much appreciated approach to ideas about both primary and secondary research. For example, following the measures taken in Cyprus in response to the crisis there, his blog (<http://www.pauljorion.com/blog/?p=51610>) contained a contribution from P. SARTON DU JONCHAY, entitled "*Cyprus, the monetary revolution on the march*". The author raised questions about international monetary law and in particular the impact of taxation in this context.

- 11) Speech by HECTOR SANTS at the FSA Chartered Institute of Securities and Investments Conference on 17 June 2010, available at: http://www.fsa.gov.uk/library/communication/speeches/2010/0617_hs.shtml.
- 12) See for example ALAIN TOURAINE, *Après la crise*, Seuil 2010, 196 pages.
- 13) In this connection, see the remarkable latest BRICS declaration (BRICS summit on 27 March 2013).