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Reform of Financial Institutions—Getting it Right

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The purpose of this article is to reflect upon the importance and the role of financial institutions before, during, and after the financial crisis and to outline proposals for alternative approaches to the financial crisis. Without an understanding of the historic development, nature and scope, and important limitations of modern financial institutions, the regulatory reform of modern financial institutions cannot be successful. The success of financial reforms and their restructuring can only be measured when modern financial institutions participate, support, and develop the real economy and support a more balanced, inclusive, and diverse social development process. This is what the really "exciting" banking and finance organizations should stand for. The regulatory reforms, bail-outs, and dominant ideas about the European banking union, for example, are impeding, rather than facilitating, hope for real economic and social recovery on both sides of the Atlantic. The method used in the present article, is legal and institutional analysis of the financial institutions. The empirical and comparative overview of the role and importance of financial institutions shows the variety of financial institutions developed in different historical and socio-economic circumstances. They show there is no one single best model of financial institutions that could be universally applicable. The design and the regulatory framework for the financial institutions should therefore take into account the overall strategy of economic and social development. In absence of any such comprehensive strategy it is unlikely that the regulatory reform of the financial institutions can be successful.

Keywords: the role of financial institutions, regulatory reform of financial institutions, the tenuous linkages between the real economy and the financial institutions, financial hypertrophy and financial crisis, alternative financial institutions

Introduction

The purpose of this article is to reflect upon the importance and the role of financial institutions before, during and after the financial crisis and to outline proposals for alternative approaches to the financial crisis. Financial institutions are commonly mentioned in academic and public debates, but their role remains inadequately understood. Financial institutions and their activities grew immensely over the last few decades. They became highly sophisticated so much, so that many of their detailed operations and transactions are only understood by highly specialized experts. This is part of the reason why they attract a lot of attention, not only for the purpose of bailing them out, but rather to better understand their role, importance, and relevance to the real economy and to the societies at large.

It is worth remembering that in the period between 1950 and 1980, financial institutions were primarily "uninteresting", "boring institutions" with the task of allocating financial resources from the savers to the

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productive activities of the society. In the period between 1980 and 2008, however, a fundamental shift in the world of finance occurred. Consequently, the world of finance and financial institutions has become one of the fastest growing sectors. The role, size, and importance of finance have changed from the auxiliary role of supporting the development of other economic and social activities to a dominant role and position in modern (Western) societies. This fundamental shift has largely gone unnoticed.

At the explanatory level, the fundamental shift in the importance of finance can be explained as a necessary, natural development of mature capitalist societies. Only after the crisis, with its epicenter in the large financial institutions of the most advanced and developed countries worldwide, has it become clear that it will not be possible to return to the path of sustainable and equitable development without comprehensive structural changes in the role and activities of financial institutions.

The primary purposes of this article are twofold: (1) to illustrate how the financial system has become increasingly dysfunctional; and (2) to illustrate the possibilities of how to redirect and reorient financial institutions in the future to again become socially valuable and useful institutions.

Real Economy, Financial Institutions, and Long-Term Development

Among the critics of the present financial environment, created in the last decades, is a significantly important and radical idea: breaking up several of the biggest financial institutions. The argument of Johnson and several other important scholars is that the best way to tame large financial institutions and prevent future financial disasters at the expense of society is to break-up the largest financial institutions. The simplest explanation of the argument is that in making financial institutions smaller, a potential collapse of certain financial institutions would not bring international finance into turmoil. When large financial institutions operate in a highly leveraged form, with a great deal of debt and very little equity, huge and unfair costs may be imposed on the rest of the economy. While the implicit subsidies provided to too-big-to-fail companies allow executives and investors to increase compensation by hundreds of millions of dollars, the costs imposed on the rest of us are in the trillions of dollars. This led Johnson to the conclusion that this is a monstrously unfair and inefficient system. Many sensible public figures are increasingly pointing this out (Johnson, 2012).

There are also other similar proposals for providing safer banking. One idea is legislating higher capital requirements. The purpose of this is to make sure banks and other large financial institutions depend more on equity and less on debt and to a binding "leverage ratio"—a requirement according to which the banks should have at least 10% in equity relative to their total assets (Johnson, 2012).

Johnson admits that even smaller financial institutions, in comparison with today's megabanks, would not be sufficient to ensure financial stability. They would ensure, however, more efficient supervision and reduce systemic risks in cases of financial turmoil.

The authors arguing in support of the limitation on the size and leverage of financial institutions also discuss, with lesser attention, the issue of the quality of these hypothetically restructured financial institutions. The open issue would remain as to whether these smaller financial institutions would be capable of providing stronger and better long-term support for the development of the real economy. Suppose that the first part of the issue can be described as a quantitative issue—the size, the cap on debt, on leverage and so on. As such, the second part of the issue can be described as qualitative. The qualitative issue can be described as the issue of the quality of financial support for innovations, for the enhancement of productivity, and for the expansion of output.

The distinction should be made between all kinds of financial activities aiming at securing long-term support for the development of a real economy and those financial activities aiming at creating benefits for the executives and investors. Needless to say, this distinction is, in reality, almost impossible to draw, but it nevertheless remains crucial. Dirk Bezemer, a finance professor from the Groningen University, is one of the few experts who pointed out this crucial, although rarely mentioned and analyzed, distinction. He has made a distinction between credit that supports economic growth and credit that fuels bubbles and subsequently hinders growth.

Bezemer's path breaking analysis starts with the recognition that current macroeconomic models do not distinguish between the credit flows that help and hinder the economy (Bezemer, 2012a, p. 3). He is convinced that the neglect of credit and debt in economic theory left us unprepared for dealing with the financial crisis. Moreover, he has pointed out the paradox that the dominant macroeconomic models of "general equilibrium" do not have "money, financial flows, credit, or debt". The models that are widely used in policy institutes, academia, and central banks, have no bank. These models assume the liabilities of all borrowers always exactly match the assets of all lenders.

The assumption is that, on the basis of accounting equality, the financial sector's assets are the real sector's liabilities. According to Bezemer, however, this accounting equality, on which macroeconomic models are based, is highly misleading and does not explain the true nature of modern finance. Namely,

> …most of that debt growth has not been due to lending to the real sector—to non-financial firms, supporting growth in wages and profit. Almost all of it was due to mortgage lending and to credit to the non-bank financial sector credit, to inflate stocks and property prices and to create and trade options, futures, and other derivative instruments. These credit flows, and the activities they fuelled—share buybacks, leveraged buyouts, securitization—create no wage or profits for the many, but capital gains for the few, and a huge net debt burden on the economy.
>
> Property and asset prices may be falling, but the debts that jacked them up are not. The threat to growth today is not a shrinking of the financial sector, but it enormous size. The accumulated claims by the non-bank financial sector cause a daily drain of purchasing power on the economy in debt services. This is money that could be effective demand for goods and services and stimulate economic growth. Nowadays, finance is stifling, not stimulating growth. (Bezemer, 2012b)

These findings have far reaching consequences for the debate on the role and importance of financial institutions in the modern economy and society. They go beyond the discussion of the size and scope of large financial institutions. On the basis of these insights, Bezemer has illustrated the process of the gradual de-linking of finances and the real economy over the last three decades. The financial institutions have turned away from supporting the real economy and from growing and developing in tandem with the real economy and society. These valuable insights by Bezemer, who has reminded us that James Tobin, when discussing the efficiency of the financial system, warned us that "… we are throwing more and more resources, including cream of our youth, into activities that generate high private rewards disproportionate to their social productivity" (Bezemer, 2012a, p. 2).

The theoretical reason for the confusion in explaining the role and importance of large financial institutions in modern societies comes from accounting equality, according to which the financial sector's assets are the real sector's liabilities. There is, however, a trade-off between "the financing of production (out of retained earnings and fresh lending) on the one hand and credit flows returning into the financial sector on the other" (Bezemer, 2009a, p. 13). As noted by Bezemer, this trade-off is absent from the mainstream models, but is crucial to understanding the crisis.

On the basis of the flow-of-funds, credit has shifted away from the real economy to the financial assets market. This shift has created its own dynamics, according to which the credits into financial assets and financial instruments increased returns. This encouraged the next cycle of credit flows, debt growth, and asset price rises. The unsustainable dynamic in the period of irrational exuberance was perhaps not viewed as deeply problematic, because the real economy developed and grew at the same time. In good economic times, the shift of credits from the real economy to the financial assets did not present a concern, due to the accounting identity assumption. This assumption created an illusion of common growth and prosperity. The longer the illusion lasted, the more destructive the social and economic consequences turned out to be.

If the above analysis is correct and the mainstream economic and legal experts and policy-makers failed to address the phenomenon, then the financial institutions turned away from supporting the real economy into extracting benefits from it. The crucial issue is how to re-connect the financial institutions and the real economy such that the financial institutions start supporting the real economy again. It is a challenge, not only in how to rebalance the power and influence the large financial institutions, but also in how to channel credit flows back into the real economy. This redirection would not necessarily make banking and finance "boring" again, but it would make sure that the financial institutions grow and develop in a sustainable manner together with the real economy and the society at large. As a result, this redirection would probably decrease returns and bonuses to large financial institutions and their executives. It would, however, spread economic, financial, and other opportunities to the larger segment of businesses, new entrepreneurs, to start up firms and to many other segments of society. The qualitative dimension of the financial reform should be added to the quantitative dimension of the financial reform.

For the time being, governments on both sides of the Atlantic pay little attention to such an alternative approach to the reform of the financial institutions. They continue to bail out the entire financial sector, regardless of the cost for the public finance, and ultimately, for the taxpayers. Their perspective seems to be that after bailing out the financial institutions, things would return back to prosperity, as witnessed in the years before the financial crisis. The problem with this approach is that the period of the so-called prosperity was based on many unsustainable and illusory premises. It was based on the supply of cheap money, on the toxic flows of excessive liquidity to increasingly inflated prices of financial assets, and on the so-called credit democracy for the citizens. Not one of the premises was sustainable and not one can be restored.

The attempt to restore the status-quo ante situation by merely making more regulations on large financial institutions would only mean that financial institutions are still not sources of support and that they may continue to present a "sustained drain of liquidity from the real sector to the finance, insurance and real estate (FIRE) sector" (Bezemer, 2009a, p. 13). This problem with credit flows, which was little understood and rarely mentioned before the crisis, continues to be unresolved. The consequences of not recognizing what Bezemer has recognized—that the credits flowing to the financial assets are distinct from the credits flowing to the real economy—go beyond the issue of the optimal size and scope of the financial institutions. Bezemer has offered another important argument to support this view:

> In the 1980-2007 era of cheap credit and deregulation, banks had every incentive to move from real-economy projects, yielding a profit, towards lending against rising asset prices, yielding a capital gain. In the 1990s and 2000s, loan volumes rose to unprecedented levels, supporting global assets booms in property, derivatives and the carry trade. The share of lending by US banks to the US financial sector—instead of to the real economy—went from 60 percent of the outstanding loan stock in 1980 (up from 50 percent in the 1950s) to more than 80 percent in 2007. (Bezemer, 2009b)

Unfortunately, the similar data for the EU are not available, but it would probably be a fair assessment that in the last few decades, the EU, before and after the creation of the Eurozone, took a very similar path of development. This means that financial liberalization, cross-border mergers, and the creation of large European banks led to a similar path of unsustainable development with negative economic and social consequences. As a result, the EU faces similar challenges in restructuring the banking sector to the US.

The challenges of restructuring the banking sector and financial markets go substantially beyond regulatory measures and quantitative limitations on the size and leverage. The crucial debate remains how to recreate a socially beneficial financial sector. In this sense, Bezemer is right when he is reminding us that the financial sector continues to be bloated and dysfunctional. As long as modern societies cannot channel credits via financial institutions primarily in the enhancement of productivity, wages, and the growth of the real economy, the efforts to bail out such a financial sector will present a drain, not a support, for the long-term economic and social development of modern societies. Therefore, the key challenge for modern societies is to restructure and redirect financial institutions to again start performing socially useful functions.

Nothing less than the future of democracy is at stake. Concern about the future of democracy in relation to the role and importance of financial institutions was very well understood by scholars, practitioners, and politicians, such as Louis Brandeis, Douglas Williams, and Franklin Roosevelt, decades ago. However, it is poorly understood by the present generation of leaders and mainstream scholars.

Another important aspect of the finance and financial institutions situation that was overlooked by most mainstream economists, lawyers, and policy-makers is that corporations, businesses, and other parts of the real economy are increasingly self-financed. This observation was almost completely ignored before the crisis in good economic times and remains to be largely overlooked today. Only a handful of scholars pointed to this issue of self-financing. Scholars who pointed out this phenomenon, including Roberto Unger, Zhiyuan Cui, and Colin Mayer, observed that relatively little real investment in the expansion of production and productivity is financed directly through stock markets:

> Corporations in all major Western countries fund almost all their capital expenditures—investment in plant, machinery, and inventories—internally, through retained earnings, in other words, through profits and depreciation. Since 1952, retained earnings have covered 95 percent of capital expenditures. Since the early 1980s, through mergers and acquisitions, buybacks, and dividend distributions, more stock has been retrieved from stock markets than has been issued. As a result, new equity as a net source of finance is negative. (Unger, 1998, p. 283)

Why is it possible that such an important and revolutionary insight has been ignored for such a long time? Part of the theoretical and practical reason lies in the nature of modern financial activities as explained previously. Another part of the reason lies with the neoclassical and Keynesian literature, according to which the accounting identity between savings and investment exists by definition. Whatever is saved is going to automatically be invested. This implies that saving cannot be wasted and money cannot be squandered in the financial casino.

The reality of modern complex financial institutions illustrates a different picture. Huge volumes of financial transactions and trading between financial institutions do not necessarily and automatically guarantee that the financial flows will be channeled to enhance productivity and output. Empirical analyses illustrate that corporations have to rely on their own savings to finance their development. This observation, put forward by economic and legal scholars Bezemer, Unger, and Cui, has been suppressed by the neoclassical and Keynesian literature. The growing gap between the financial institution and the real economy was less problematic in good

economic times—when the underlying fragility and unsustainability of the financial arrangement was not taken seriously. It remains unaddressed today. Without addressing it, it is difficult to determine how it would be possible to overcome the ongoing crisis, except in the form of a temporary "kicking the can' manner".

In addition to the theoretical reasons, practical reasons for ignoring the problem of the inefficient allocation of scarce resources lay ahead. Financial markets and financial institutions grew immensely in the last decades. Confronting them directly would require courage and wisdom, as well as the theoretical knowledge and practical skills rarely seen of public figures, such as policy-makers and advisers. It remains more convenient to marginally improve the regulatory framework while bailing out many of the failing financial institutions with taxpayer money, rather than approach a comprehensive and strategic restructuring of the financial sector. Strategic restructuring would require a quantitative restructuring in terms of size and caps, as well as a qualitative restructuring of financial institutions in order to reconnect them with the real economy and the rest of the society.

These are the reasons why the approach toward banking bail-outs and toward the banking union in the European context is far from efficient from a broad social and economic perspective. The entire approach needs to be re-directed. The regulatory efforts should follow, not precede, such a reorientation. The best start in a new direction, such as this, is to focus on what worked best in the past. These were networks of small local banks which provided long-term support for the development of small and medium sized local businesses. Local banks have traditionally been a backbone of local and regional development in many advanced economies, including the US decentralized banking sector and the German system of Landesbanks. They have a much better insight into the needs, possibilities, and potential of local businesses and have a much bigger stake in the success of local and regional development. They represent one alternative possibility of how to secure a deepening of finance in place of the futile process of financial hypertrophy (Lothian & Unger, 2011, p. 30).

Other forms of financial institutions with much larger stakes in supporting the long-term competitiveness of the real economy, and with much greater interest in the more equal and inclusive access to credit, should evolve. The difference between financial hypertrophy and financial deepening was established by Unger and Lothian. They explain the contrast in the following way:

> By the hypertrophy of finance, we understand increase in the size of the financial sector, of its share in profit, talent, and influence, regardless of the service that it renders to the real economy. By financial deepening, we mean the intimacy of the relation between finance and the real economy: not only consumption but also and above all production and innovation. (Lothian & Unger, 2011, p. 27)

Institutional innovations in the area of finance are something substantially different than the proliferation of financial instruments and financial innovations in the last decades. Financial innovations served the purpose of enhancing the volume of trade without the ultimate goal of supporting the development of the real economy. Would not it be really exciting for banking to re-connect the financial institutions with the development of the real economy, so that the next generation of talented bankers would participate, support, and help develop the real economy and society at large? It is true that the banking bonuses for the top executives and the returns on equity could (and should) be closer in line with the developments, returns, and rewards in the real economy, but such a realignment would serve the real social needs and return prospects for the many excluded parts of the population.

On the basis of the analysis presented above, it would be necessary to multiply and diversify financial

institutions in order to reconnect the world of finance with the world of real economy. For example, the role of venture capital, which provides equity to start-up firms, the role of regional development funds, the role of pension funds (on the need to activate pension funds for the purposes of long-term economic development (Unger, 1998, pp. 148-150), and the role of other financial institutions can all contribute to the diversification of financial institutions. It also contributes to more innovative ways for how to provide long-term support for the real economy and its restructuring for start-up firms, industrial innovations, and the productivity enhancement (the possibility to transform the US financial system toward more equitable and more efficient system) (Dymski, Epstein, & Pollin, 1993).

A reorientation of the financial institutions is not without risks. The key point is that decisions for when and how to provide finances for the real economy must be taken on the basis of a high level of expertise and an understanding of the real economy. It must also be independent on any political meddling at the local, regional, and national level. Policy-makers should support the improved links between the financial sector and the real sector, but they cannot, and should not, interfere with the professional decisions of which investment opportunities deserve high quality financial support. The same principle applies, even in the case of public venture funds. However, these venture funds present a rare, but potentially promising, vehicle of the future socially inclusive economic development.

Financial deepening, as a qualitative and quantitative contrast to development, would lead to a more balanced, more diverse, and subsequently more inclusive development of the financial sector, real economy and society at large. It would require strong leadership and a renewed opening of space for the economic, social, and financial initiatives bottom-up approach, as well as better chances to pursue a comprehensive economic and social reconstruction. It would present a task, as Lothian and Unger (2011, pp. 28-33) suggested in their proposal, to return the financial institutions from the position of bad master again into a position of good servant to the economy and society.

Such a restructuring of the financial institutions would certainly require broader social and economic visions of modern economies and societies and would require broader social alliances. It would not be a magic wand, but certainly present a more transparent, more balanced, and more inclusive approach to the economic and social recovery. Needless to say, it would also meet with strong opposition in the form of present financial and political oligarchies which continue to stymie any coherent and comprehensive approach to the recovery beyond hopeless but allegedly necessary bail-outs and banking unions in the trans-Atlantic world.

Conclusions

Since the beginning of the crisis, many valuable proposals for how to tame financial institutions were put forward. Among the most well-known is the Volcker rule, which is the prohibition of internal hedge funds, internal private equity funds, and proprietary trading in commercial banking institutions. They include a return to "narrow banking", limitations of the size and leverage of financial institutions. Laurence Kotlikoff suggested a limited purpose banking, in which banks are not allowed to borrow short and lend long. In addition, all risky assets must be held in mutual funds (Johnson & Kwak, 2011, p. 6461). In practice, new legislation and regulation, such as Dodd-Frank, was adopted. In a long and protracting legislative procedure—including heavy lobbying and opposition from the Wall Street—a comprehensive new legislation was adopted by the US.

According to Johnson, the Dodd-Frank Act presents an important step forward in supervising and regulating large financial institutions and a missed opportunity. It is a complex legislation which leaves a

dizzying number of details to regulatory discretion. Thus, it will depend largely on the integrity, quality, independence, and professionalism of the regulatory bodies. More specifically, the courts will have to supervise and regulate the financial institutions better than they have in the past.

Lawyers at Davis Polk counted 243 new rules and 67 new studies required by the Dodd-Frank Act. Despite the comprehensive legal framework, many important aspects are exempted from legislation, such as the new requirements for trading and clearing derivatives, which includes an exemption for "commercial end users" that use derivatives for hedging purposes. Johnson has pointed out that the size of that loophole turns out to be largely dependent on the wording of the rule defining exempt transactions (Johnson & Kwak, 2011, pp. 4396-4413).

It will be many years, before a judgment on the efficiency of such legislation could be made. It will also take many years before it will become clear as to whether the President's announcement, when signing the Dodd-Franck Act, of the American people never again being asked to foot the bill for Wall Street's mistakes and about the transparency and risk reduction of such a bill (Johnson & Kwak, 2011, loc. 4324-44) will be possible to verify. It is already possible, however, to say that the Dodd-Frank Act does not present as substantial a reform of the financial institutions as the Glass-Stegall Act, in the New Deal era, despite the fact that the magnitude of the problems and issues related to the role of financial institutions is bigger today than at any other period of industrial, financial, and social development.

Alternatively, more thoroughly thought out approaches toward financial sector restructuring are needed. According to the available reports and data, in the EU, the European commission has approved €4.5 trillion (37 percent of EU GDP) in state aid measures to financial institutions between 2008 and 2011 (EU Observer, June 2012). According to the report by former European Commissioner Liikanen:

> During October 2008 to end 2010, European governments used a total of €1.6 trillion of state aid to support the banking sector, in the form of guarantees and liquidity support, recapitalisation, and asset relief measures. It was perceived that, without government intervention, a systemic crisis with serious consequences for the economy would have materialised. (Liikanen report, 2012, p. 20)

The real tragedy is, however, that despite this massive support in state aid and other support measures, many EU member states economics and their regions economies continue to be in recession with high unemployment and with very weak financial institutions. The situation is not significantly better in the US, despite a more integrated federal financial system. The challenges ahead for the policy-makers today are even bigger than at the eruption of the crisis. "Kicking the can down the road" has its limitations too.

As a starting point for a more substantive reform of financial institutions, it can be helpful to turn to Bezemer, who argues convincingly that there is no neutral regulatory framework. Only after the nature, character, and scope of modern financial institutions is understood and only after a significantly reoriented role of the financial sector in the modern economy and society is envisaged, it becomes possible to turn to the adoption of a substantially different regulatory framework. Such a framework would be more inclined to provide high quality financial support for the development of a real economy, for its active restructuring, for enhancement of productivity, and for the benefit of more socially inclusive overall development. Namely:

> More specifically, the balance sheets of firms, households, and governments, and the regulations in the economic system on what sorts of balance sheets are being allowed, co-determine what forms new credit flows can take, how much there can be of it to different sectors (e.g., to the FIRE sector versus the real economy), and consequently how the economy will evolve. These will not the only factors shaping the economy, but neither can they be fully abstracted from,

> as is current practice in much of economic research. In sum, there seem to be important contributions that accounting researchers can make to economics—rather than just the other way around, as is sometimes suggested. (Bezemer 2009a, p. 33)

There is no doubt that financial institutions and financial instruments will develop in the future. Shiller is correct about that and also about the many socially useful innovations that were developed in the past. The trouble is, however, that financial institutions in the last three decades contributed less to the public good than they did before the crisis. Many mainstream academics, policy-makers, monetary authorities, financial institutions' representatives, and corporate media defended the liberalized, deregulated financial institutions. The biggest challenge remains how to make the financial institutions serve broad social interests and make sure that they are doing their best in delivering better products and services. Unlike Shiller, who believes that improved regulations would be sufficient enough for financial institutions to serve broad social interests in the best possible manner (Shiller, 2012, loc. 432-52), many other scholars, described previously, argue convincingly that a mere regulatory reform will not be sufficient. Independent minded scholars from all over the world would make a historical mistake if they did not deeply understand the substantive nature of this disagreement. They should also not pay attention to the possible alternative ways to approach the financial, economic, and social reconstruction of modern societies in different parts of the world.

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