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What to do about Europe's market fundamentalism:

embrace the European tradition of social banking and investing

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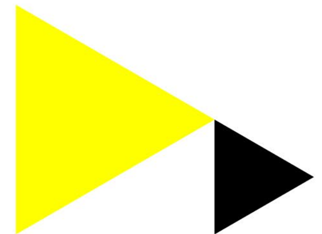

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What to Do about Europe's Market Fundamentalism: Embrace the European Tradition of Social Banking and Investing

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Abstract

In this article, a revised version of a response to the European Commission's 2013 Green Paper, *Long-Term Financing of the European Economy,* we argue that European thinking is trapped in a narrow conceptualization of financial markets, which hinders long-term sustainable development and an economy that should serve future generations. We then make a case for a hybrid banking system that will enable a freer and more sustainable European financial market.*

*This article is based on the response of the Network for Sustainable Financial Markets to the European Union green paper on long-term finance. Dr. Frank Jan de Graaf, Amsterdam University of Applied Sciences/University of Amsterdam Business School, and Sean Kidney, Climate Bonds Initiative, were major contributors to the Network's response, which was supported by: Individuals supporting this response: Daniela Carosio, Director, Sustainable Equity Value; Ralf Frank, Secretary General, DVFA Society of Investment Professionals in Germany; John Fullerton, President & Founder, Capital Institute; Hazel Henderson, President, Ethical Markets Media; Chris Hewett, Fellow, The Finance Innovation Lab; John Jarrett, Partner and Co-Founder, BHJ Partners; Keith Johnson, Chair, Reinhart Institutional Investor Services;Cary Krosinsky, Executive Director, Sustainable Financial Markets; Kazutaka Kuroda, Social Media Director, Network for Sustainable Financial Markets; Jeremy Leggett, Chair, SolarCentury; Tim MacDonald, Stonebridge Partnerships; Michael Musuraca, Pension Fund Manager; Nick Silver, Callund Consulting; Steve Podmore, CEO, Transform Capital Management, UK; Peter Sweatman, Chief Executive, Climate Strategy & Partners; Raj Thamotheram, CEO, Preventable Surprises; Gabriel Thoumi, CFA, Integra LLC; Mark Van Clieaf, Managing Director. MVC Management Corp.; Stephen Viederman, Chair, Finance Committee, Christopher Reynolds Foundation; Prof. Cynthia Williams, Osler Chair in Business Law, Osgoode Hall Law School, York University, Toronto. Signatories are supporting this document in their personal capacities; organizational affiliations were listed for identification purposes only.

What to Do about Europe's Market Fundamentalism: Embrace the European Tradition of Social Banking and Investing

Early in 2013, the European Commission published the Green Paper, *Long-Term Financing of the European Economy*. Although the general approach of the paper was positive, it demonstrated that European thinking is trapped in a narrow conceptualization of financial markets that is hindering long-term sustainable development. In our response, we argue for a hybrid banking system that will enable a freer and more sustainable European financial market.

A strong and free financial market in the European Union needs a healthy social infrastructure in which stakeholders and the financial sector interact and ensure social goals. Investments should be aligned with social well-being to strengthen societies over the long term.

Europe could benefit from a renewed emphasis on financial markets in which businesses and other stakeholders work in concert, something that was once a longstanding tradition. Cooperatives in banking and insurance, pension funds in which employees and employers collaborate, development banks and other forms of private-private partnerships, and public-private partnerships have built European economies. New changes, like those in the environmental field, call for hybrid organizations and institutions comparable to such cooperatives.

In light of the recent financial crisis and continuing instability in developed market economies, a normative debate about how to create healthy economies is needed. If we change our thinking about markets, we can redevelop our financial system.

Market Fundamentalism

Over the last three decades, the EU's free-market ideal has been narrowly interpreted, resulting in a concept that can be called "market fundamentalism." We define *market fundamentalism* as a model in which market interventions are limited to legal measures to ensure effective financial transactions (Stiglitz 2004).

Market fundamentalism is based on the idea that the role of governments is only to set the regulatory constraints of market participants. The better the regulation, the more effectively market participants will operate and the more an economy will flourish. In this model, apart from addressing regulatory frameworks, governments do not actively participate in the market.

This first assumption is further developed by other assumptions of "neoclassical" economic thinking. For example, "clear and transparent standards lead to a market with one level playing field" (assumption 2), and "all information should be available," so that participants, who are only focused on their own interest (assumption 3), can make rational choices (assumption 4). Given these assumptions, the market will be unbalanced at some points, but in the end, it will find some kind of balance between demand and supply. Here on the outskirts of economics, at the overlap between economics and management science, we hit an extensive debate on methodology. Stiglitz (2004, 2010) is well known for criticizing the influence of mainstream economic thinking on development policies. Economists have certain ideological premises that strongly influence their analysis. (See also Frankfurter 2006.) These preferences can also be related to cultural and institutional circumstances (for example, Nooteboom 1999; Aguilera and Jackson 2003; Jackson and Deeg 2008).

Neoclassical thinking is mainstream today in economics. For example, transaction-cost economics, institutional economics, and behavioral economics are linked directly to neoclassical thinking and have all influenced current financial theory. Modern portfolio theory is built on these assumptions. Slowly, however, the critique of modern portfolio theory is increasing. Slager and Koedijk (2007) state that very little has been empirically proven in investment theory. Both Taleb (2007) and Soros (2008) criticize the nonreflective character of modern economic theory as it is applied in investment.

Others have made similar assessments of these methodologies. Nooteboom (2000) argues that economic methodology does not take reflectivity into account or, in other words, it neglects the social constructive dimension of financial markets. Frankfurter (2006) questions the unwanted consequences of current market practices and tries to outline some suggestions for a different market paradigm.

At a micro-economic level, agency theory and contract theory, in which firms are seen as a nexus of contracts, align with this theoretical perspective. Current agency theory has been the critical bridge that some economists (mainly in institutional economics and finance) and law scholars have used to make comparative analyses between various economic models. Within this tradition, the work of La Porta, et al. (1999; 2008) is well known, even to having been given its own acronym, LLSV. These authors try to compare economic systems by relating the level of legal protection extended to shareholders to the successful financial development of a country. Traditionally, a country's development has been measured in stock price development, but more recently, it has also taken into account some GDP measures.

Critical to this concept is the role played by institutions; mainstream economics follows North by defining institutions as "the rules of the game" (North 1990, 1), but only as the

legislative rules. This view contrasts with a more sociological view of the economy in which normative and cognitive aspects of economic transactions are also taken into account (e.g. Aguilera and Jackson 2003; Nooteboom 2003; Jackson and Deeg 2008).

According to this view of market fundamentalism, financial markets operate like any other market. Private parties should lead in the market and preferably should be quoted on the stock market to ensure optimal transparency, which, in turn, should lead to the lowest costs of capital for individuals and companies.

In recent years, the widespread adoption of market fundamentalism by European regulators has led to a neglect of what had been a fruitful European tradition in finance, one in which more subtle mechanisms were emphasized.

Building on a Successful European Tradition of Finance

The key objective of financial markets is to enable individuals and companies to invest in economic activities that serve long-term sustainable development.

Gaining access to capital is a critical mechanism for economic development. At various times in history, private initiatives were unable to tackle socio-economic challenges. Not purely economic, these challenges addressed social issues, such as poverty in rural areas, post-war reconstruction, or economic development in post-unification East Germany. When money was too expensive to enable certain investments, people searched for alternatives and developed structures that would facilitate such investments.

At those times, hybrid partnerships were formed. Public-private partnerships were one form; banks with a cooperative structure, another. When founders did not choose a private company structure, it was most often because risks were difficult to assess—which generally led to a higher cost of capital—and/or certain social objectives were not being met. But most often, it was a combination of both difficult risk assessment and neglect of social objectives. For example, cooperatives were founded in the nineteenth century to develop rural areas where, at the time, lending money to poor farmers was seen as high risk. Risk-sharing in a structure that differed from a private company gave farmers and other small entrepreneurs access to capital.

Europe's Long Tradition of Public-Private Partnerships

Europe has a long tradition of public-private partnerships in finance. In many countries, such as the Netherlands, the main financial institutions were founded by the state or by groups of individuals trying to solve market inefficiencies. *Landesbanken*, cooperative banks, state-owned banks, banks founded by groups of merchants and factory owners are

all examples of this in Europe. (To compare, see Millineux and Terberger 2006; Mettenheim and Butzbach 2012.) One of the first stock markets came into existence when merchants of Amsterdam tried to share risks that they could not undertake individually or share with limited private parties. In developed economies, national states have acted similarly, and in many countries, noncommercial institutions run pension fund systems.

In recent years, similar, European-style, institutions have been founded, such as the European Investment Fund owned by the European Commission, the European Investment Bank, and European stakeholders. Close cooperation among the various partners in finance is called for in the principles of the organization and is demonstrated within its structure and within the partnerships that execute the policies.

Thinking about Financial Regulation Has Been Driven by False Assumptions

Substantial parts of the financial markets are actually organized by noncommercial institutions, even though the mainstream thinking about regulation is that profit-driven, publicly owned companies are dominant (De Graaf & Williams 2009).

The *social* objectives of banks have been underestimated in the last three decades. Neoclassical economists and financial markets theorists have instead emphasized the role of a free market with private companies. They portray privately held, publicly listed banks as role models but portray state-owned companies and other financial organizations that have a different structure as disturbing.

This viewpoint has important implications in the thinking on banking in general and for banking regulation more specifically.

A blind belief in markets as the main force for economic development and discipline is one of the reasons for the current financial crisis according to many critics (Turner 2009; De Graaf and Williams 2009; Stiglitz 2010). For these critics, agency theory guides regulator behavior, and economic participants serve their own interests solely. To control agents (the managers), the shareholders (the principals) need complete information and full control measures. And so, clear control measures—regulation and contracts—are seen as necessary for effective organizations and markets.

However, in Europe the roots of a more complex system exist.

Complement Regulation with Emphasis on Governance and Reputational Interdependencies

Traditionally, the continental European perspective on banking and control has been different: Besides regulation, it has emphasized the role of diverse governance structures

and the role of reputation—regulation and contracts were generally not enough. In this framwork, banks should be designed to create interdependencies between various stakeholders; when one of the stakeholders misbehaves, it should lose its reputation, which will weaken its market position.

Mechanisms influencing reputation have been critical in all forms of finance that have a social objective. They are even more critical in organizations that combine a financial objective with a social one. This is because social objectives and social impact are difficult to measure and, therefore, to regulate and formulate in contracts; as a result, mechanisms relating to reputation and other forms of social control are important.

Within structures in which financial and social objectives are met, long-term finance becomes possible. Long-term finance needs two standards: return on capital and contribution to societal goals. At the moment, however, a "dis-intermediation" is occurring, in the words of Standard & Poor's. Banks are withdrawing from various markets, and other financial institutions are not able to fill the gap left by this withdrawal. Small- and medium-sized enterprises (SMEs), for example, can no longer rely on a long-term stable relationship with their bank and they often need to find alternative financing.

Other means of financing are slowly developing: for example, credit unions in various European countries are growing; mutual guarantees are becoming more important; and institutional investors are developing various bonds to reach other parts of the market.

But Europe's long-term investment challenges—from a social and financial perspective—require mobilization of the full breadth of financial means. When looked at this way, banks and other financial institutions play an essential facilitating role in society, a role in which the "serving function" of finance should be the cornerstone of regulation and governmental policies. Most of the time, this means that hybrid forms of organizations, such as those discussed above, are necessary.

European institutions should lead in promoting the "serving" role of finance to create long-term sustainable markets, learning from a tradition in which stakeholders, governments, and banks together tackle social and environmental issues in a financially sound way.

Hybrid Finance Systems Offer Long-Term Success and Growth

In this article, we have discussed the role of finance in long-term sustainable economic development. We argue for a hybrid finance system, in line with the European tradition.

Financial innovation is of critical importance, as are free financial markets. Only one prerequisite is critical here. Finance should *serve* society by facilitating long-term sustainable economic development. This condition should be the most important principle for regulators. Therefore more hybrid banking structures should be developed.

Finance should be a sector that develops financial instruments that help society to tackle social and environmental issues, instruments that make long-term economic growth possible. The idea that financial companies are there for financial purposes only is a fallacy—a kind of fundamentalism that helps very few in the long term.

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Biographies

Dr. Frank Jan de Graaf is professor (lector) of Corporate Governance and Leadership at the Amsterdam University of Applied Sciences and lectures in the executive education program of the University of Amsterdam Business School.