Bank to the Future

El Escorial Statement on Banks and the Financial Crisis

BankTrack is the international network of non-governmental organizations monitoring commercial banks. BankTrack advocates for a banking sector that is socially and environmentally sustainable and which provides services that benefit society as a whole. Rooted in this perspective, and in light of the financial crisis, we call for fundamental reforms in the global financial system, particularly in relation to the role and regulation of banks.[1]

The world financial system is on the brink of collapse. The crisis that is pervading the banking system has increasingly spread to other sectors of the economy, affecting the lives of millions of people living in both developed and developing countries.

Irresponsible and unsustainable behaviour of banks, driven by greed and kept unchecked by a failing regulatory system, has been at the core of the crisis. In our view, the crisis has three main dimensions:

- *A financial and economic crisis*: The financial meltdown has been characterized by a collapse of trust among banks, bank insolvency, and deleveraging. More importantly, it has led to a severe crisis of confidence in the banking sector overall, confidence on which the sector ultimately depends. As distrust takes over and money flows dry up, credit has tightened, and the world is heading into a recession whose depth and duration no one can predict.

- *A social and environmental crisis*: The reckless, speculation-driven expansion of the financial markets has led to a staggering disconnect between the amount of capital at play in the “casino” economy (where money is solely made off money) and the real economy. That same capital could have been deployed to investments that would help meet both the basic needs of millions of people, as well as finance the global energy shift urgently needed to avoid a global climate catastrophe. Unfortunately, banks’ financing activities in the real economy usually fall far short of this potential, and instead often harm local communities and ecosystems around the world.[2]

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[1] This statement was drafted at the BankTrack annual strategy meeting which took place in San Lorenzo de El Escorial, Spain on 6 November 2008. As the economic crisis is constantly changing and further unfolds, BankTrack will continue to collaborate with other NGOs, social movements, trade unions and civil society at large to refine our analysis and to develop a common approach. BankTrack’s vision for sustainability and accountability in the financial sector is elaborated in the Collevecchio Declaration (2003): www.banktrack.org

[2] See for example, BankTrack’s Dodgy Deals: www.banktrack.org

The financial crisis has also diverted international attention, support, and financial resources from addressing urgent issues facing the world's poor, such as the continuing food crisis. Humanitarian groups stress that the suffering of the 290 million people hit hardest by today's food crisis could be relieved if the G8 countries could give just two extra cents for every $1 they have spent so far on bailing out the banking industry.[3]

- *A governance crisis*: Through widespread political engagement over the last decade, the financial industry has effectively usurped the power and role of financial regulators and supervisors.[4] Banks' successful deregulatory efforts have allowed them to engage in excessive risk-taking in the pursuit of short-term profits, at the cost of more prudent value-creating strategies. As a result, between 2000 and 2006, the net profits of banks have more than doubled.

To deal with the serious problems that have now arisen, and to prevent their future reappearance, BankTrack believes that these three dimensions of the crisis need to be dealt with at once.

Steps to solve the governance crisis

As the crisis has demonstrated, self-regulation is no regulation. For years, governments have taken a hands-off approach to the sector which has allowed risky activities to go unregulated, and banks to easily circumvent existing rules.

Weak regulations led to the creation of the massive "shadow banking system," which was largely responsible for the expansion of unregulated, exotic securitized products and credit derivatives. For example, in 2007 the notional value of over-the-counter derivatives amounted to about US$596 trillion, which is almost 10 times larger than world GDP.[5] This huge unregulated part of the financial sector increased systemic risks and played a key role in creating the financial crisis. Largely operating out of tax havens that have been left equally undisturbed by the world community, some shadow banks are actually non-bank institutions such as hedge funds. However, other such operators have been established by banks themselves (for example, structured investment vehicles) to avoid regulations such as capital adequacy requirements.

[3] NGOs warn poor countries neglected in financial bail-outs, 17 October 2008, http://www.oxfam.org/en/pressroom/ngos-warn-poor-countries-neglected-financial-bail-outs

[4] For example, in the US, the financial industry has more than quadrupled its federal campaign contributions since 1990, and is now the leading source of support to federal candidates and parties. see Center for Responsive Politics, http://www.opensecrets.org/industries/background.php?cycle=2008&ind=F and http://www.opensecrets.org/industries/indus.php?cycle=2008&ind=F

[5] Bank for International Settlements, http://www.bis.org/statistics/otcder/dt1920a.pdf

It is also clear that under a system of self-regulation, banks were not able to take any meaningful coordinated action to stem the crisis in which they found themselves, forcing governments around the world to bail them out with massive amounts of tax money. To avoid this situation in the future, BankTrack believes that it is necessary to:

- *Get banks out of politics:* Decreasing the political influence of banks (and all corporations) is critical. According to Nobel Prize winner Joseph Stiglitz, "Much of the inadequacy of current regulations and regulatory structures is the result of financial markets' political influence, in many countries through campaign contributions. These deeper political reforms, including campaign finance reform, are an essential part of any successful regulatory reform."[6]

- *Require banks to seek a social license to operate*: Society must regain the means to control and correct banks, and redefine banks' primary role as investing in the real economy and advancing environmental sustainability. Banks need to earn their social licenses to operate and provide products and services which serve, rather than harm, the public interest.

- *Ensure democratic participation in designing a new global financial order:* BankTrack strongly supports the development of a new global financial order to prevent future financial crises. However, new policies and institutions must be developed in a manner that is participatory and democratic, and ensure strong participation and support from developing and emerging countries. Large segments of their populations are being badly affected by the present crisis, even they had no responsibility in creating it.

Steps to solve the environmental and social crisis

Today the world is in need of a "Green New Deal." Such a deal would not seek to stabilize the economic system as it is, but aim to transform it into one that helps solve the pressing social and environmental problems the world is facing. The fiscal spending that is necessary to stimulate crisis-affected economies entering recession should be directed at achieving social justice, the promotion of sustainable production and consumption systems, and the transition of the world's economies onto a low carbon path.

Banks, particularly those that are now bailed out with tax money, have an important role to play in this economic transformation. It must be a role based on serving the public interest, rather than safeguarding the profits of the few. Given their power and important role, banks can and should deploy capital in ways that promote the restoration and protection of the environment and help create sustainable economies.

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[6] Joseph Stiglitz, Professor, Columbia University, Testimony to House Financial Services Committee, October 21, 2008 at http://www.house.gov/apps/list/hearing/financialsvcs_dem/stiglitz102108.pdf

For example, banks can play a pivotal role in funding the transition to a low-carbon economy by moving away from fossil fuel-based energy projects into low/no carbon options and by accounting, reporting, and committing to reduce the greenhouse gas emissions in all their financing portfolios.

Policy makers too have a critical role in establishing a new bank regulatory regime that proactively stimulates this economic transition. For example:

- *Bank supervision:* Sustainability-oriented standards should be incorporated into all bank supervision, including the granting of licenses, and the extension of central bank-provided credit and insurance.

- *A sustainable Basel Capital Accord*: Banking regulators should mandate the inclusion of environmental and social issues into risk assessment processes for bank financing activities. One possibility is to include a set of sustainability criteria into the Basel Capital Accords capital adequacy ratios.

- *Green screening of customers:* Know Your Customer (KYC) guidelines are anti-money laundering (AML) mechanisms used by banks to screen potential depositors. In a similar vein, "Green KYC" guidelines should be developed, which would require banks to conduct environmental and social due diligence for both commercial depositors and borrowers, with the aim of prohibiting lending to corporations that do not comply with environmental and social laws. In addition, existing AML requirements should be tightened to halt the proceeds of corruption, illicit natural resource deals and tax evasion from entering the financial system.[7]

- *Transparency:* Banks should be completely transparent about their risk assessment processes, decision-making procedures, clients, and transactions. For example, banks should fully disclose their financing activities in the extractive industries and infrastructure sectors, which often have high environmental and social impacts. In light of widespread public distrust about banks' intentions, the issue is no longer how much transparency banks can allow, but how much secrecy they can afford. Such transparency is already best practice among some ethical banks.

Steps to solve the financial crisis

Current efforts to reform the financial markets must include **clear prohibitions** on certain financial practices and structures.

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[7] For example, AML requirements should apply to all financial actors and transactions, including hedge funds and private equity. The Financial Action Task Force should also launch a name and shame initiative focusing on those jurisdictions that are failing to implement their AML rules.

- *Eliminate the shadow banking system* by regulating all unregulated financiers and financial products. In addition, some financial practices simply should be forbidden. It does not make sense to establish regulatory frameworks and reporting standards, while at the same time allowing financiers to circumvent them through off-the-book transactions. For example, banks should not be allowed to create any structured investment vehicles and/or special purpose entities which allow them to avoid regulations.

- *Abolish tax havens:* Secrecy jurisdictions are established not only to allow companies, financiers and individuals to evade taxes, but to avoid regulations as well. With tax havens resulting in capital flight of some US$500-800 billion per year[8] from developing and emerging market countries alone, severely eroding the tax base of these countries, they have significant impacts on the world's poor. No jurisdiction should be allowed to continue with its tax haven status. As part of the effort to eliminate such havens, banks should be explicitly prohibited from establishing or conducting transactions with entities based in these jurisdictions.

In addition, financial regulations should be **dramatically strengthened:**

- *Regulate alternative investors,* such as hedge funds and private equity funds, and introduce significant new transparency and reporting requirements. For years, alternative investments were lightly regulated, under the rationale that only wealthy, sophisticated investors participated in such funds, which often employ risky and speculative investment strategies (and which we now know, also create systemic risk and foster instability). Today, however, pension funds, university endowments as well as public and private financial institutions have significant exposure to these funds, greatly magnifying their impacts on ordinary citizens and the global financial system. This requires much stronger regulation of the alternative investment space.

- *Limit leverage:* The crisis has made clear that extraordinarily high returns often are linked to an excessive amount of borrowed money (leverage) and/or temporary wealth associated with inflating bubbles. As over-borrowing and the subsequent deleveraging are drivers of the current crisis, the use of leverage in investments and lending should be limited. For example, banks should have a leverage ratio in addition to stricter capital adequacy standards, and non-bank institutions should also have capital and leverage requirements.

- *Curb derivatives:* It has become clear that derivatives are potentially dangerous products. As with other potentially dangerous goods -- for example pharmaceutical products -- regulators demand robust testing

[8] Baker, Raymod, *Capitalism's Achilles Heel,* 2005.

before a product can be sold. Equally, derivatives should be checked for their long-term impacts and whether they serve a legitimate hedging purpose (i.e. help producers to anticipate and adapt to price fluctuations). Only legitimate hedging instruments should be allowed, and they should be standardized and traded in regulated exchanges.

The need to curb speculative derivatives trading is particularly critical in food- and energy-related commodities markets. Huge swings in commodity prices and speculation-fueled spikes in food and energy prices hurt the world's poor. Food and energy should not be treated like chips in a casino.

- *Reduce incentives for excessive risk taking*: Banks' perverse incentive structures, like stock-options and short-term, volume-oriented bonuses, stimulated excessive risk taking and effectively led to greed-oriented decision-making at banks. For example, CEOs and bankers have compromised lending standards (including environmental and social policies), taken on too much leverage, and unscrupulously pushed risky products onto the public. Not only should bankers' executive compensation be drastically limited, but the role of bonuses in remuneration systems should be changed so as to reward long-term financial success and the implementation of environmental and social policies and programs.

We face a time of dramatic change that presents unique opportunities. Now that the once-dominant forces of market fundamentalism have been discredited, a new, equitable, and sustainable future can be built on the rubble of past excesses.

El Escorial, Spain
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