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The fight against financial crimes

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In my May statement to this group I expressed the concern that organized crime, and in particular financial crime has moved from the margins to the mainstream, from local to global, from traditional to hi-tech offenses. Today I'll assesses how this unacceptable situation came about and what can be done to change it.

My earlier diagnosis was severe. The malpractices of banks today have no precedent in size, shape and complexity: money laundering, interest rate manipulation, foreign exchange rigging, cheating on credit cards, inflated billing, tax avoidance, promotion of toxic products, insider trading, reckless risk-taking, abuse of mortgage bearers. These crimes are more than violations of the law: they are the result of ethical failures, the loss of the moral compass that should guide behaviors.

In May I also noted reasons why the political establishment fails to sanction the financial crimes. *First*, because the drifting of financial activity into massive short-term gains mirrors what is happening in politics: excessive overvaluation of the present, and excessive discount of the future. *Second*, the condoning of financial malpractices results from the collusion between public and private affairs, national treasuries and bondholders, party officials and campaign donors.

Insane financial profits, mostly illegal and always immoral, are the result of several enabling conditions. I'll point to three of them.

The *first*, half a century old, resulted from the evolution of the monetary system from a standard based on a given quantity of a valuable mineral (gold), to the fiat money system, based on currencies that derive their value from government regulations and laws. Ever since this financial 'transubstantiation' -- the conversion of intrinsically worthless paper notes (dollars, euros, etc) into valuable assets (homes, cars, jewels) – has been Mammon's great ritual performed daily in central banks.

This condition brought about a *second* development: the independence of central banks. Originally thought desirable so as to remove political constraints to the management of national money, central bank independence, in Europe especially, evolved into freedom to operate outside society's system of checks and balances.

Financial de-regulation was the *third* development. The relaxation of controls (for example, the abolition of the Glass-Steagall act in the US) has vastly increased the ability of the financial markets to allocate capital over time, space and instruments. It has also sparked the explosive growth of financial transactions, which now greatly exceed those driven by international trade. The result has been the de-linking of money movements from the real economy.

Earlier I spoke about the bonds between finance and politics. In fact, the combination of the fiat money system, central banks' independence and financial deregulation, forged the dangerous link between commercial and central banks. Indeed, the past few years of (esoteric) monetary experimentations have grossly expanded central banks' balance sheet (by a staggering \$6 tn, equal to 10% of global GDP), leaving financial markets over-dependent on central bank support. Economic growth is slow, but stock markets have reached new heights as most of this newly printed money has flown into the financial sector. The premises for the next crisis have been established.

Fighting the united front of finance, politics and central banking is complex. Building upon Jesus Estanislao's note, I propose *bottom-up approaches* (individual behaviors), as well as *top-down solutions* (legislative instruments). I would add an over-arching third dimension: *international measures*, that relate to what nations can do by acting together. Since economic and financial crimes have mutated into a global threat, the world community must mobilize in a global effort.

(1) <u>The bottom-up approach</u>

At the time of the financial crises, public opinion believed that there would be retaliation against those who caused it: new rules, major fines, prison terms. Popular movements were active in the US -- from main street to Congress. In Europe, public resentment manifested itself at the electoral level, with anti-establishment parties showing strong anti-banks psychosis.

Common people must maintain the pressure on governments to act:

- To name, shame and boycott the banks involved in illicit activity;
- To urge the removal of culpable management;
- To push authorities to impose verifiable sanctions;
- To protect whistle-blowers who risk retaliation;
- To support media reports about financial crime;
- To publicize awareness that crime increases income disparities.

(2) <u>The top-down approach</u>

Governments must bring banking back to its origins: honest intermediation between those who save and those who invest. This means changing the permissive environment that has allowed the proliferation of a banking culture riddled with theft, speculation, fraud, usury and gambling.

Recent steps in this direction have been uneven. In the US, only half the rules required under the Dodd-Frank reform Bill (to replace the Glass-Steagall Act) have been written, most of them in a diluted form. Lobbying by banks has eviscerated the Volcker rule, originally at the heart of the Bill. The rules against reckless compensation have yet to be written, as do rules to contain regulatory arbitrage (shadow banking), and to prevent stock exchanges manipulations (high-frequency trading).

In Europe, the Liikanen report proposed reforms concerning risk management, corporate governance and bank resolution mechanisms. It also advocated executive pay restrains. To date an awkward coalition of officials (who approved only a watered-down EU banking union) and bankers (who blocked the remuneration proposals) derailed the reform.

Of course re-regulation can only do so much. The financial crisis taught us that market practitioners are always steps ahead of regulators. Behavior is more a matter of conscience than a question of rules. Nonetheless, I urge the adoption of several national measures:

- To resolve orderly distressed institutions without taxpayer money;
- To allow financial institutions that break to law to fail;
- To sentence to prison the managers of corrupt institutions;
- To strengthen anti-corruption and financial intelligence agencies, especially the anti-money laundering regime;
- To include financial crime into anti-organized crime (mafia) justice;
- To protect whistle blowers who report banking malpractices.

(3) <u>The horizontal (international) approach</u>

Because of the universal desire to preserve open, global financial markets, reform action must go global, so as to increase the resilience of the system, reduce contagion, and mitigate the cyclical nature of financial flows. The literature on this subject is huge. In my view, the key internationally agreed measures are:

- To strengthen the balance sheets of banks and prudential supervision therein (Basel III);
- To block regulatory arbitrage (shadow banking);
- To improve collaborative anti-money laundering efforts (FATAF);
- To promote information and operational coordination so as to avoid that financial criminals seek refuge across the border;
- To retaliate against states that offer protection to financial criminals;
- To push for the recognition of international jurisdiction for economic and financial crime (ICC).

To conclude, no regulatory improvement, no technical effort to clean up balance sheets, no effort to assure respect of Basel criteria, no stress test can improve the integrity of the banking system unless and until the ethics of institutions and of the players therein improve. Cultural change – *in bono* as *in malo* – requires time. It took a long time to get into the present mess. Will we succeed before the next crisis?