Fidelis International Institute

Some thoughts about the financial crisis and Church's Social Doctrine.

By Gilles Denoyel

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Thank you very much to have invited me to speak today in that prestigious university. Father Barrajón, I have met during the Executive Summit on Ethics for the Business World, held in Vatican City last June with the sponsoring of your university, suggested to me to speak about the financial crisis and the contribution of C.S.D to a possible solution for it.

Taking the risk to disappoint you, at the start of the presentation, I am not sure that there is one "solution" to this crisis, with the meaning of a technical recipe to avoid, in the future, any new crisis like that: I am afraid that, for various reasons I will come back later on, crisis is inherent to the capitalist system and more specifically, to the financial system. But, I am sure that the church can afford more: a lighting on the way the world could function better and our role within it. It is the points I desire to develop with you : which light is given on the financial sector, on the market, on the globalization by CSD, and more specifically by Caritas in Veritate.

But before that, to set the scene, I propose to present to you:

- A short comment about some characteristics of this crisis
- Then, a snapshot on where we are within that crisis and what has changed

I. SOME ASPECTS OF THE PRESENT CRISIS

1) I will present my own view, which is surely partial, and probably influenced by the fact I am working for the banking industry.

2) I don't intend to recall in detail the numerous root causes of the crisis, which are pretty well known:
   - Macro economic imbalances, between surplus countries (China, Japon, Germany) and countries with external deficits (USA, US, Spain…)
   - Too laxist monetary policy in the US after the 9.11
   - Shortcomings in the banking regulation
   - And, undoubtedly, serious dysfunctioning among a number of banks

3) I would just to stress that, in a certain meaning, **this crisis is a pretty classical one, but taking place in a new context** – the context of globalization – which gives to it a more dramatic impact: this is the first real crisis of a globalized world.

a) Why did I say it is **a classical crisis?** Because, at the heart of the crisis – both the initial one, starting in 2007 with the subprimes, and the present phase around the Eurozone – is **over borrowing**, as it has been the case very frequently in the past – let's just think to the 1929 Crack.

- **Over borrowing** by **households**, notably involved by home acquisitions at ever-increasing prices: it has been the case in the US, with the terrible example of the subprimes – where the strong political will to encourage everybody to buy his home regardless of his financial capacity lead to these borrowers nicknamed NINJA's[1] – but also in the UK, or in Spain, where you find now ghost holiday resorts ; on the contrary, it was not the case in Italy or France, where households have a low level of debts
- **Over borrowing by banks,** some of them having abused of the leverage effect – the capacity, for instance, with 5 of capital resources to lend 100, 20 times more: this leverage effect is normal and is at the heart of banking activity, but some banks, notably in the US, abused of it with a leverage of not 10 or even 20, but 30 or even 50. It is easy to understand that, with such a leverage, a pretty small amount of bad assets can wipe out all the capital and lead to bankruptcy.
- **Over borrowing by governments**, as it appears now within the Eurozone, but not only, with the US or the UK not really better in terms of public debt and deficit, and Japan far worse
- And finally, as already mentioned, **over-borrowing by whole countries**: a large part of western countries were just leaving "beyond their means".

b) **But the new context of globalization** has dramatically increased the impact of the crisis:

- First, in a globalized world, the consequences of an event in a part of the world are rapidly global, as we have seen with the subprime crisis, where the evolution of the Case Schiller index, reflecting average home prices in 20 American cities had impacts everywhere in Europe
- And, as globalization is intertwined with a massive extension of financial activities, cyclical tensions of these activities - which are unavoidable thanks to the above mentioned leverage effect - have more and more severe impact on real economy, as we could have observed just after Lehman Brothers failure.

II. Where we are in this crisis? Which kind of structural changes could we see?

There is a pretty common view that the crisis, we are living from now more than 4 years, has not really changed the way the world is functioning id est all the dysfunctioning of the capitalist system in general and of the financial system in

[1] NINJA's : No income, No Job, No Asset

particular, are still there. I don't share that view and I think that very significant changes have started to take place, even if we have only seen, up to now, their first steps:

1) It is the case, first of all, on **the geopolitical level**

a) The crisis has already had a major consequence, by significantly accelerating the **move of the centre of gravity of the world economy** from the West to the East and the South, id est to the big emerging countries, starting with the BRICs – Brazil, Russia, India, China. This move has started before the crisis, thanks to the very strong growth of these countries, but the nearly collapse of Western economies in 2009 and again now has accelerated the path.

b) It is possible, if not certain, that the crisis will have provoked a second major geopolitical change, this time **on our old continent, Europe,** if our governments finally manage to put in place **a new governance,** helping Eurozone countries to have more coherent economic and fiscal policies, which is the absolute condition of success for a common currency. Let's hope it will be the case, as, if it's not, it could be a nightmare!

2) **Very significant changes have also started to take place in the financial sector**, and I wanted to develop that a bit more, as it is probably not clearly perceived by our environment.

a) **The banking landscape has already been significantly modified** :

- in the US, there were 5 major investment banks : 3 of them have disappeared (Lehman Brothers) or been acquired (Bear Stearns, Merryl Linch) and the 2 remaining (Goldman Sachs or Morgan Stanley) have modified their banking status.
- in Europe, a series of banks have been shaken or even nationalized, in the UK, in Switzerland, in Germany or in France
- globally speaking, the weight of the banking industry within global market cap, which had exploded in the previous years, has massively decreased.

b) More structurally, **decisive changes in the regulation and the supervision of the banking industry** have already been decided and will have major impacts in the coming years, some of them possibly unintended.

- Contrary to the common view, it is not at all true that nothing happened on the banking regulation: various specialized bodies have elaborated, at the request of the G20, the most significant set of reforms ever seen in that industry, far more important, for instance, than those decided in the US after the Great Depression, notably because they target, at least in principle, all the major banks in the world. These reforms will be endorsed by the next G20, poised to meet in Cannes in November, then implemented in the various countries, notably in Europe.

- Without entering too technical details, the **major elements of these reforms** are:

- **Massively tighter financial rules** to be respected by banks, in terms of capital and liquidity : to give just one example, up to now, it was needed for a bank to have only 2 of pure equity to support 100 of assets, where, in the future, for the largest banks, you will need 10, that means 5 times the previous minimum.
- A **specific tightening for market activities** (where we have to recognize that the rules were particularly lax).
- **Strengthened powers of supervision for the regulators,** both at local and international level, with in Europe, for instance, the creation of the European Banking Authority.
- In some countries (UK and, may be, France), **a mandatory split between retail and market activities.**
- **Increased duties for the banks** in terms of risk monitoring (which has clearly been failing in a number of banks).
- And, finally, **specific rules for the bonuses given** to risk-takers, notably market traders.

- These reforms are not already in place, because in these pretty complex matters, it takes time to elaborate new rules and to get the agreement of a large number of countries, and I don't pretend that it will change everything, but I can insure you that **they will have very significant impacts on the banking industry**.
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Some of these impacts are targeted, to correct past excesses, for instance:

- The reform will decrease significantly the profitability of the sector, which was probably abnormally high in the past, in sum, you will need more capital to get lower returns
- They will modify substantially market activities, some of them disappearing because no more profitable
- They will finally impact these famous bonuses given to the traders, which were surely excessive

But some other consequences could be unintended:

- Credit will become scarcer and more expensive, notably for households and small companies.
- Some financial risks incurred by large corporate for their basic activity, for instance foreign exchange risk for exporters, could become harder to hedge.
- Money will flow from the highly regulated banking sector to the unregulated shadow banking and from heavily supervised European banks to less regarding Asian countries.

These latter risks are surely not a reason to do not reinforce the regulation, but request some attention to avoid full mistakes.

III. After these pretty technical elements, I would now to come to the **Church's Social Doctrine and to Caritas in Veritate and express which lights they give us on the globalized market economy, financial activities and the crisis**

1) **Let's start with Church's Social Doctrine**

I have to confess that I discovered CSD very recently, 4 years ago, through the reading of the CSD Compendium, published in 2004 by Justice and Peace Council chaired, at this time, by Cardinal Martino: with a small group of French executives, we worked on the Compendium during one year and we found it a remarkable book, I strongly encourage you to read if not already done.

a) **At a first glance, Compendium is a bit disappointing about financial activities**, because they occupied only a few paragraphs among several hundred of pages: may be it is a mean to bring finance people, who easily tend to think about themselves as "masters of universe" to more modesty.

b) The Compendium mentions explicitly a **series of positive impacts** of financial activities, when they fulfil their basic function to finance the economy, for instance:
   - Capital resources mobility contributes to a better capital allocation
   - Financial innovations are needed
   - Savings is key for economic development, so the role of the banking sector in this area is also key

c) **At the same time, the Compendium expresses a number of reservations and alerts, around 3 main ideas** : decoupling between finance and real economy ; instability risks ; and inequalities between countries. I would come back to the 2 first ideas, because they are strongly correlated with today's theme.

i) The Compendium criticises strongly t**he tendency of financial activities to function for themselves,** forgetting their role which is to finance economy

- This criticism could appear as excessive as banks can't function durably separately from the economy.
- But it is true that this tendency was significantly reinforced during the years before the crisis, as illustrated, for instance, by the incredible volume of financial transactions – let's just mention the outstanding amount of those financial products named "derivatives", estimated around 600 trillions USD, ten times the size of annual world GDP or by the factoring of this myriad of products and structures with strange names you may have read in the papers: ABS, CLOs, CDO, SIV…
- More fundamentally, the specific positioning of banks in the economic chain facilitates a kind of auto-preferential logic:

- Banks are (may be, I had better to say: were) in a privileged situation to keep for themselves a large chunk of profits, which explains the high level of compensations.
- They benefited, up to now, from an asymmetrical position against risks: it's the question of the "too big to fail", where large banks earn a lot of money when times are good and are rescued by governments when the crisis arrives (even not all the banks behaved like that).

ii) The Compendium emphasized **the risks of instability** provoked by financial activities: for a book published in 2004, we have to recognize that it was premonitory. Indeed, the financial crisis has clearly revealed in a number of banks (however within different ranges):

- Very poor risk monitoring
- Systematic under-evaluation of risks
- Excessive confidence paid to mathematical models, which appeared seriously flawed
- Innovative products out of control
- Operational failures, including rogue trading
- And, in addition, inadequate supervision

All these weaknesses have strongly contributed to the financial crisis, creating a huge instability for the markets first and then for the whole economy.

2) **Caritas in Veritate**, published in July 2009, after being several times delayed – may be for a part, because of the crisis – does not address, directly, the subject of the financial crisis, but **gives some very rich leads on globalization, market economy and corporate life.**

Obviously, it is not a technical document, giving precise solutions to answer the questions raised by the crisis. It is a theological approach aiming to promote "integral human development". And I think it is far more important.

I will take only a few points, but a number of pages are worthy to be read, and read again, notably the introduction, which says nearly everything in the first sentence.

Let me quote it:

"Charity in truth, to which Jesus Christ bore witness by his earthly life and especially by his death and resurrection, is the principal driving force behind the authentic development of every person and of all humanity".

a) **First theme: the globalization**

Caritas in Veritate is the first encyclical letter in a largely globalized world. It is very interesting to notice that, in spite of all the criticisms against globalization –let's think to the altermondialist movements or, more recently the various "indignados" demonstrations, not only in Spain, but also in the UK or now near Wall Street – the encyclical letter don't hesitate to mention the positive impacts of globalization, even if stresses also its dangers.

Let's see for instance § 33:

"It has been the principle driving force behind the emergence from underdevelopment of whole regions and in itself it represents a great opportunity. Nevertheless, without the guidance of charity in truth, this global force cause unprecedented damage and create new divisions within the human family".

Or § 42:

"The processes of globalization, suitably understood and directed, open up the unprecedented possibility of large-scale redistribution of wealth on a word-wide scale: if badly directed, however, they can lead to an increase in poverty and inequality, and could even trigger a global crisis. It is necessary to correct the malfunctions".

b) **<u>Second theme: the role of the market</u>**

On this point also, the encyclical letter is very balanced, when it would have been easier in the present context, where market economy appears as suffering serious failures, to be only critical.

The letter recognizes **<u>usefulness of market</u>** – for instance in § 35 : "**In a climate of mutual trust, the market is the economic institution that permits encounter between persons"** – and even of profit – look at § 21 : "**Profit is useful if it serves as a means towards an end that provides a sense both of how to produce it and how to make good use of it"**.

But immediately the letter underlines they can't be "exclusive goals" (§ 21).

There is a very interesting analysis of **<u>the relations between the market, the State and Civil Society</u>**: the letter suggests to go beyond the ordinary split between these 3 actors and, on the contrary, to encourage interpenetration between them, which appears to me as quite relevant. Look at § 39 : "**When both the logic of the market and the logic of the State come to an agreement that each will continue to exercise a monopoly over its respective area of influence, in the long term much is lost".**

<u>The relations between market and ethics</u> are also underlined, for instance § 45 : "**The economy needs ethics in order to function correctly – not any ethics whatsoever, but an ethics which is people-centred"**. I think it is totally true and it is interesting to notice that shareholder value is no more the unique mantra referred to by business leaders, as it has been the case before the crisis. May be you have heard about Jack Welch, which has been the mythic CEO of General Electric in the US for 20 years and was the "king of shareholder value" : the same person declared recently that "shareholder value is the dumbest idea in the world – it is a result not a strategy" .

And, more and more, large corporate refer to their **<u>values,</u>** because they have experienced that it was no more feasible to manage a very large organization only with rules and procedures and only **<u>shared values</u>** were able to address the complexity and the diversity of real life. It is the case, for instance, in my own organisation, where we launched from the start of this year a comprehensive programme on our values. Stephen Green, a former HSBC CEO has written a quite interesting book about this aspect, entitled “Good Value”, where he summarizes the interest of such a kind of approach by saying “Values add to Value”.

c) **About finance, the encyclical letter starts with some criticisms**, which appear as largely justified:

- § 21 critics **“the damaging effects on the real economy of badly managed a largely speculative financial dealing”,** even the distinction between speculation and useful market activities is not so easy.
- § 36 says: **“Economy and finance, as instruments can be used badly when those at the helm are motivated by purely selfish ends”**. We recognize here the attack against this auto-preferential logic, which was already denounced by the Compendium.

And, in the Chapter 5, § 65, **the letter gives 3 major orientations** both to public authorities and to finance people:

- **“Finance – through the renewed structures and operating methods that have to be designed after its misuse, which wreaked such havoc on the real economy – now need to go back to being an instrument directed towards improved wealth creation and development”.**
- Second, **“financiers must rediscover the genuinely ethical foundation of their activity, so as not to abuse the sophisticated instruments which can serve to betray the interest of savers”.**
- Third, authorities have to put in place **“regulation of the financial sector, as to safeguard weaker parties and discourage scandalous speculation”.**

I totally support these views and I told you the very significant changes, which have been decided in the banking regulation.

It is interesting to notice that the letter mentions also the **responsibility of the investor**, which is, too often, forgotten.

d) I will end this presentation by mentioning **two other themes** developed by Caritas in Veritate, because they appear to me as very important to consider within business life, notably in financial activities: **gratuitousness** and **technical mindset**.

i) At first sight, **the reference to gratuitousness** made in the encyclical (let’s quote §36 : the principle of gratuitousness and the logic of gift … can and must find their place within normal economic activity”) **looks paradoxical,** notably inside the business world, firstly aimed at economical performance. However, it appears rapidly that, if the company life were to be reduced to the mere contracts, performances wouldn’t be such as they are and the firm couldn’t even properly function[2]. Collaborators’ engagement, trust between the different hierarchical levels, the multitude of interpersonal relations inside the company[3], totally exceed the contracts and are, according to me, the first elements of gratuitousness, of gift, inside the business.

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[2] cf CIV §37 : “Economic life undoubtedly requires contracts,… but it also needs… works redolent of the spirit of gift”

[3] cf CIV %36 : “the C.S.D holds that authentically human social relationship of friendship, solidarity and reciprocity can also be conducted within economic activity, and not only outside it or after it”

But it is possible to go beyond that point, notably matching the leader's role in the company. Business leaders have obviously **an exemplarity role** in the incarnation of the values of the firm. They also have, in addition to their driving mission, **a listening role**, the importance of which increases all the more in a world where authority is no longer only top down. And it leads to the role of "**servant leadership**" – mentioned by Stephen Green – A "leadership whose essence is not psychological domination, but which seeks to share itself, to set an example, to instil the instinct of leadership in others…"[4]. It seems to me that this kind of attitude refers to gratuitousness, gift and finally "caritas, love received and given"(C.I.V par 5). Surely, I am describing the ideal leader, we can't pretend to be, but we may target to.

ii) Then, the encyclical letter, in its chapter 6, speaks about technology. After having pointed out the merits of technological progress, "a profoundly human reality…[which] expresses and confirms the hegemony of the spirit over matter" (CIV §69), it underlines the **dangers of technology, when it pretends to be "self-sufficient"** (CIV §70).

Multiple forms of this danger appear in the business world. I would underline only some aspects:

- Extension of quantification to all the sectors of the business: in that approach, only counts which is measurable[5].

- Absolutizing financial targets, often on the short term.

- Permanent monitoring of individual performances and compensations based on formulaic calculations.

- You could add the extensive use of communication tools (Email, blackberry…), which can create a real addiction, or, in the financial domain, the blind (and excessive) trust in mathematical models.

- You could also mention the increasing taylorism in service businesses, the caricature of which being the scripts given to the call-centre operators to speak to the customers.

Confronted to those numerous deviations, **the encyclical letter calls to bring a more human approach back:**

- Combining quantitative data and more qualitative elements, for instance when appraising an employee.
- Avoiding a too directive and sterilizing management and according a larger place to initiative as part of a trust-based relationship, accordingly to the subsidiarity principle, dear to the Church[6].
- Introducing kindness in the relationship
- Or, in finance, becoming aware of the limits of models and of the central role of human judgment.

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[4] S. Green, Good Value, p.179.
[5] C.I.V § 70 : « But when the sole criterion of truth is efficiency and utility, development is automatically denied »
[6] C.I.V § « A particular manifestation of charity…is undoubtedly the principle of subsidiarity, an expression of inalienable human freedom »

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To end this presentation, I would express my gratitude towards the Church which, through such texts as the CSD Compendium and the encyclical letter Caritas in Veritate – and, surely, many other ones, I am for instance thinking to Saint Benedict's rule –, provides a fruitful support to the business people searching for integrity.

I thank you for your attention.