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# Problems and Opinions

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*Giovanni Ferri\**

## **FROM SHAREHOLDERS TO STAKEHOLDERS FINANCE. RECOVERING SUSTAINABLE FINANCE<sup>1</sup>**

### **1. THE EFFECTS OF THE FINANCIAL CRISIS AND THE WAYS OUT**

In this paper I will argue that re-regulating finance while preserving and augmenting its stakeholder-oriented component – as opposed to the shareholder/profit maximizing component – is needed not only to restore the stability of finance but also to mend the market economy, saving it from the distortions and the excesses of financial capitalism. The Great Crisis, started in 2007–2008 with the debacle of the subprime mortgage segment in the US and having a second wave centred on the Eurozone sovereign debt crisis in 2010–2012, has deployed wide ranging effects, especially on the rich countries. The unsustainable debt overhang was the result of several causes: global imbalances, excessively lenient monetary policy by the Federal Reserve and the downside of deregulation/liberalisation of finance. I will leave aside the first two and concentrate on the third. Slower growth, global imbalances and financial liberalization brought about unsustainable debt/GDP levels in various advanced countries (fig. 1), while the situation was much better in emerging economies (e.g. the BRICS). Since excessive private debt with

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<sup>1</sup> This paper draws partly on Ferri (2013) and on D'Apice and Ferri (2010).

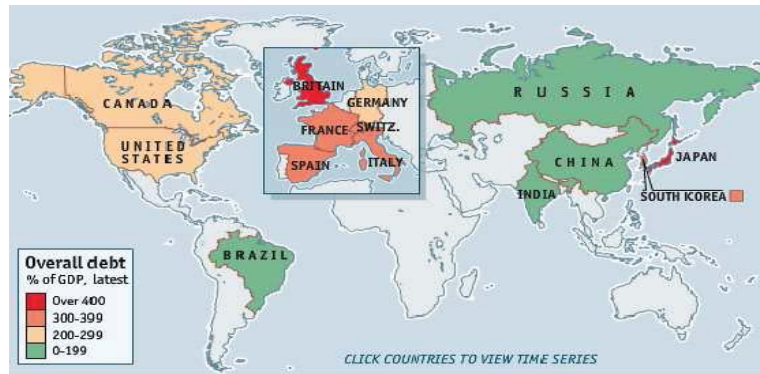
the crisis translates into higher public debt, it is appropriate to consider the sum of private and public debt as a ratio to GDP. Figure 2 shows the long-run trend for the US. Indeed, it is impressive how the trend accelerated since the 1980s concurrently with financial deregulation and liberalization.

When the great leaders of the world gathered in London for the 2 April 2009 meeting of the G20, what they had in mind was the most acute phase of the first – US originated – wave of the crisis. The financial markets had been in a tailspin since the Lehman Brothers bankruptcy in September 2008 and the first signs of recovery were extremely uncertain. Therefore, they took a strong stance announcing stiff measures to re-regulate finance. Among the proposed measures the ones key to our discussion were:

- ❖ scaling up IMF resources for crisis prevention and assistance;
- ❖ establishing the Financial Stability Board to provide early warning of and address macroeconomic/financial risks;
- ❖ reshaping regulatory systems to identify and take account of macro-prudential risks;
- ❖ extending regulation and oversight to all systemically important financial institutions, instruments and markets, for the first time including systemically important hedge funds;
- ❖ endorsing and implementing tough new principles on pay and compensation and supporting sustainable compensation schemes and the corporate social responsibility of all firms;
- ❖ taking action, once recovery is assured, to improve the quality, quantity, and international consistency of banks' capital. In future, regulation should prevent excessive leverage and require buffers of resources to be built up in good times;
- ❖ taking action against non-cooperative jurisdictions, including tax havens, standing ready to deploy sanctions to protect members' public finances and financial systems;
- ❖ calling on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards;
- ❖ extending regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest.

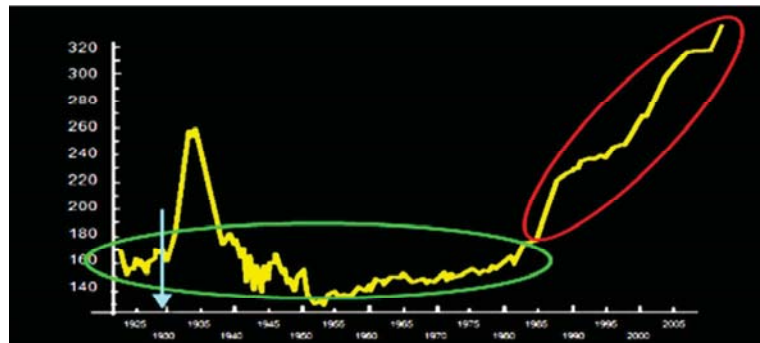
However, unfortunately, finance seems to be heading exactly to business as usual and most of what was promised at the London meeting has not been delivered. And even the rules that are introduced (e.g. the Dodd-Frank Act) appear to be lagging and could prove largely ineffective.

Figure 1. Public Plus Private Debt to GDP in Selected Countries



Source: The Economist (2010).

Figure 2. Public Plus Private Debt to GDP in the US: Long-run Trend



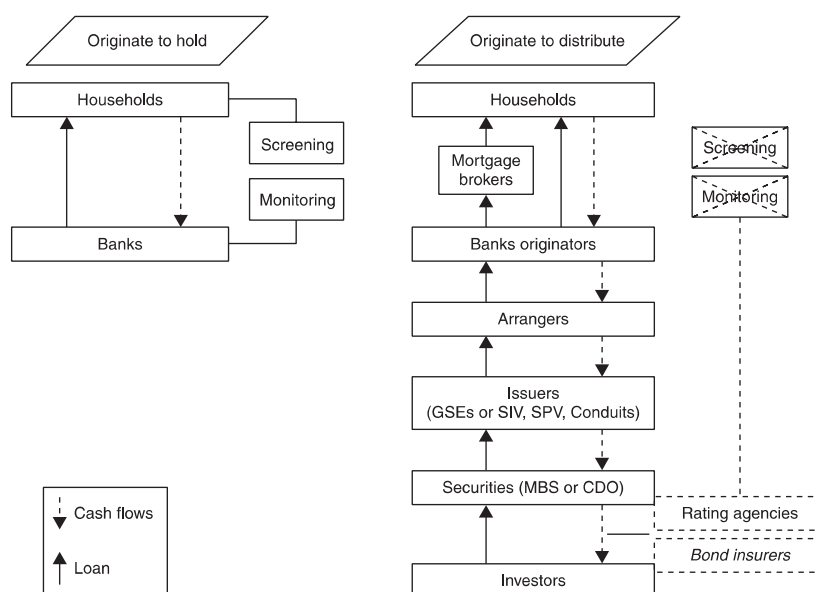
Source: Martenson (2009).

## 2. THE DEEP MISTAKES OF THE ‘LIGHT TOUCH’ REGULATION OF FINANCE

Bank lending standards became lower – i.e. more loans go to less worthy customers – because many banks move away from their traditional business model. Indeed, securitisations drastically changed the banking model: from the ‘originate to hold’ (OTH) to the ‘originate to distribute’ (OTD) model (fig. 3). In the OTH model the loan is a simple operation between the bank and the borrower. On the contrary, in the OTD model the loan origination is a complex operation (like a multistage

production process) involving various subjects and hinging on financial markets. While OTD promotes risk diversification, it jeopardises the two fundamental activities – screening and monitoring – performed by the banks to reduce the risk of granting loans to unworthy borrowers. Beside that unfavourable transformation from OTH to OTD, a further contribution to the worsening of lending standards in the US is given by the flourishing of a parallel, unregulated banking system, the so called shadow banking system. The importance of the shadow banking system, which was virtually nil until the late 1970s, starts increasing thereafter, thanks to financial deregulation and liberalisation. By the mid 1990s the total liabilities of the shadow banking system outrun those of the regulated banking system. Ten years later, before the start of the crisis, the total liabilities of the shadow banking system approach 20 trillion USD, dwarfing the 13 trillion USD of the regulated banking system.

**Figure 3. The bank business model: from OTH to OTD**



Source: D'Apice and Ferri (2010).

Those transformations – reducing the risk-control efficacy of the regulated banks and letting the new breed of shadow banks take the lead – heightening systemic risk, i.e. the risk of collapse of the entire financial system, emerged to a large extent because of a misconceived approach to regulating finance. In this regard, the dominant approach followed the 'evolutionary view' of finance.

Following the early promotion of Goldsmith (1966, 1969), the evolutionary view postulated that financial markets be more efficient than banks at managing risks. Thus, as suggested forcefully by Bryan (1988), banks should move from the old model (lend and keep the loans, OTH) to the new model (lend and sell the loans, via securitisation, OTD).

Regrettably, banks' role as certifiers of loan quality was neglected but that role was there only with the OTH model and not with the OTD model. As we already noticed, granting loans to sell them rather than to keep them endangered banks' incentives to perform in depth screening and monitoring of the borrowers, so that lending standards rapidly deteriorated. And the evaluation of the creditworthiness of the loans underlying securitisations fell back on the rating agencies who founded such evaluation on past historical default rates, but these rates were based on the OTH model and, thus, the agencies systematically gave overly optimistic ratings.

On more general terms, for too long we had a 'crossed-eyed' theory of finance. In fact, on the one hand, the theory of financial markets is based on the assumption of complete markets and of investors holding perfect information. But, on the other hand, the theory behind the existence of financial intermediaries assumes the fundamental role of asymmetric information – the lender knows less than the borrower about the true quality of the latter – and of delegated monitoring – whereby depositors entrust banks to screen out and monitor those who will be granted credit. When, with liberalisation, financial markets became dominant, banks' practice and even regulatory principles (e.g. IAS, Basel 2) moved toward financial market type activities while weakening banks' credit function. In a sense, we applied to banks the theory, which, if adequate to financial markets, is certainly inappropriate to banks. There is a clear lesson here: it's wrong subordinating banks to financial markets (and also the opposite would be a mistake). Rather, we need to build on the banks-markets complementarity, as suggested by Allen and Gale (2000).

### **3. THE CURRENT RE-REGULATION PROVIDES MORE OF THE SAME**

The current re-regulation (e.g. Basel 3) just requires more capital for banks, following the past approach of 'mechanical quantification' of risks. Alas, we know that current measures of risk (e.g. the Capital Asset Pricing Model – CAPM or the Value at Risk – VaR) are probably misleading as they are based on untenable assumptions such as the often posited hypothesis of normality in the distribution of risks.

Let's consider the case of the CAPM, which assumes orthogonality between sovereign risk and private risk, i.e. lack of correlation between the former and

the latter. This assumption is deeply questioned by the EU sovereign debt crises. Orthogonality would require that sovereign risk (typically hypothesized to be zero) be uncorrelated with private risk. This is the way we can derive the CAPM fundamental formula:

$$ER_i = r + \beta_i (ER^m - r)$$

where  $ER_i$  is the equilibrium expected return on risky asset  $i$ ,  $r$  is the risk free rate (proxied by treasury bond returns),  $ER^m$  is the equilibrium expected return on the diversified portfolio and the coefficient

$$\beta_i = \text{cov}(R_i, R^m) / \text{var}(R^m).$$

The fallacy of the orthogonality of risks assumption is evident when governments save distressed banks: then the Credit Default Swap (CDS)<sup>2</sup> spreads drop for banks and rise for sovereigns.

It seems that the right way to go about that would be to acknowledge that we need to revise risk pricing models. Instead, the authorities use stress testing. In the aftermath of the crisis, various authorities such as the Financial Services Authority for the UK, the European Banking Authority for the EU and the International Monetary Fund at the global level calculated stress tests. In a stress test the authority looks at how robust a financial institution is in certain crashes, a form of scenario analysis. However, this scenario analysis is calculated around the risk measures provided by the traditional instruments. As such, though potentially useful, stress tests make neither a sufficient nor a necessary condition. If the risk is overestimated (underestimated) by the traditional measures, stress testing is not a sufficient (necessary) condition.

#### 4. THE NEED TO CATER FOR DIVERSITY

More generally, we should acknowledge the difference between financial risks vs. bank credit risks. Following the recalled assumptions of the theory of financial markets, financial risk management may well exhibit the benefits of diversification, i.e. since the underlying risks are 'objective' and observable, the suggestion "don't put all your eggs in just one basket" seems cogent. On the contrary, given the assumptions of the theory of financial intermediaries, bank credit risk management could feature the benefits of specialisation, i.e. as the

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<sup>2</sup> The CDS price can be considered as a proxy of the risk premium because these derivatives protect against the risk of default of a company or sovereign issue.

underlying risks are ‘subjective’ and hard to observe, this seems to imply that it would be efficient for each intermediary to specialise in overcoming asymmetric information about specific customers rather than diversify their lending across borrowers they know less about.

If we accept the reasoning we just proposed of the benefits of specialisation in lending, then we could also contemplate the possibility that different bank business models will deliver different abilities to manage bank credit risks. Thus, it would appear crucial to distinguish investment banks and wholesale commercial banks – likely better equipped to manage financial risks – from retail commercial banks and cooperative banks – probably more prepared to deal with true bank credit risks.

The reasoning just outlined would have obvious consequences in terms of separating financial market risks – and the intermediaries specialised in dealing with these risks – and bank credit risks – together with the intermediaries having a vocation to deal with these risks. Not surprisingly, this issue was key both in the Volker rule – a ban on the speculative ‘proprietary’ trading for commercial banks – embodied in the Dodd-Frank Act and in the Vickers’ Report, introducing the principle of ring-fencing between commercial banking and investment banking.

## **5. WHAT CAUSED THE “LENTO PEDE” OF FINANCIAL RE-REGULATION?**

The obvious question is: why is financial re-regulation advancing so slowly? Otherwise said, why, using Latin, is it walking with such a ‘lento pede’? To answer this question we can gain important insights looking at what supported the re-regulation of the 1930s. Many observers give credit to the ‘Pecora Commission’ as being the key driver of that re-regulation. Thus, since the working of that Commission had been long neglected, it is worthwhile to recall the basics of it.

The Pecora Investigation was an inquiry begun on March 4, 1932 by the United States Senate Committee on Banking and Currency to investigate the causes of the Wall Street Crash of 1929. The name refers to the fourth and final chief counsel for the investigation, Ferdinand Pecora. Born in Sicily and having migrated to the US in his early childhood, Ferdinand Pecora (January 6, 1882 – December 7, 1971) was a lawyer and judge who became famous in the 1930s as Chief Counsel to the United States Senate Committee on Banking and Currency during its investigation of Wall Street banking and stock brokerage practices. A member of the New York bar since 1911, Pecora was assistant district attorney in New York City (1918–1929) earning a reputation as an honest and talented prosecutor who helped shut down more than 100 bucket shops. Because of his tough reputation, Pecora was not appointed District Attorney. He left the district attorney’s office for private practice, where he remained until 1933. Ferdinand Pecora was appointed Chief Counsel to the U.S.

Senate's Committee on Banking and Currency in January 1933, the last months of the Herbert Hoover presidency by its outgoing Republican chairman, Peter Norbeck, and continued under Democratic chairman Duncan Fletcher, following the 1932 election that swept Franklin D. Roosevelt into the U.S. presidency and gave the Democratic Party control of the Senate.

Pecora's investigation unearthed evidence of irregular practices in the financial markets that benefited the rich at the expense of ordinary investors, including exposure of Morgan's "preferred list" by which the bank's influential friends (including Calvin Coolidge, the former president, and Owen J. Roberts, a judge of the Supreme Court of the United States) participated in stock offerings at steeply discounted rates. Spurred by these revelations, the United States Congress enacted the Glass-Steagall Act, the Securities Act of 1933 and the Securities Exchange Act of 1934.

Why, again, was there no substantive action after the London G20 meeting of early April 2009? How do we explain the differences with respect to the 1930s? Indeed, this time we lacked a Ferdinand Pecora to disclose the – often difficult to confess – sins of the late phase of financial capitalism. However, the Pecora Commissions don't come out of the blue. And, perhaps, this time the conditions on the ground were not favourable. First of all, there was a fundamental weakness of the Obama administration, which placed a high bet on health insurance reform and could not deal with many fronts at the same time. Perhaps even more important, expansionary economic policies – suddenly contradicting the deep credo of the free market ideology – avoided that recession turn into depression. So, the lessons of John Maynard Keynes made it more difficult to build the momentum for reform.

## **6. THE CONCEPT OF THE POLITICAL-ECONOMY CYCLE OF FINANCE**

In my view, capitalism alternates phases in which free markets expand (e.g. globalisation) and deepen (e.g. the emergence of new sectors as a result of innovation) with phases characterised by more regulated markets when rules and/or state intervention in the economy tend to be more pervasive. Over the decades, this alternation may be represented as a political-economy cycle of finance. This allegory helps read the events of finance between the 1930s and the present day.

Indeed, financial instability tends to intensify with the extent of the unfettered free market economy. By and large, freer markets sooner or later build imbalances and inefficiencies in price setting mechanisms and, consequently, in the allocation of resources. This occurs when excessively optimistic expectations about future developments evolve and the financial system fuels such misplaced assumptions, leading to excessive indebtedness in the economy. As a result, a speculative



bubble – that is usually identified as such in retrospect – is formed. Eventually, this triggers an epochal systemic crisis, which marks a turning point to change direction towards stricter regulation of the marketplace. In our interpretation, this represents the end of one cycle and the start of a new one.

In fact, solving the crisis requires, in general, two types of actions. The first one consists in the intervention by the state that – fully or partly – takes on itself the losses suffered by the financial institutions in a way to rebuild trust in them by individual investors and savers and to restore the functionality of the financial system. This action may even require (some) nationalisation of banks. The second action entails stiffening regulation and supervision of finance, assembling a framework consistent with pursuing the stability of the financial system. At the international level, the new set-up for financial stability may be crowned by the emergence of a new monetary order centred on the economic power that has come out in hegemonic position from the crisis, whose currency will become thereafter the reference for international exchanges. More generally, solving the crisis implies imposing limits on the free market, beyond the financial system, thereby often swinging the balance from the global to the national dimension of economic processes. This scenario is similar to what is usually known as de-globalisation.

However, over the long run (it may take decades), the regulatory framework tends to lose its consistency and the economic system begins to operate again in an uncontrolled financial environment. Three main factors push in this direction. First, the financial system on its own tends to breed innovations. Alas, financial innovations – though generally beneficial – short-circuit the logic and the substance of the stability controls set up with re-regulation and may undermine the functioning of the international monetary order. Second, the process of market extension – to exploit the international opportunities – and of market deepening – with the start of new business segments, often linked to innovations – needs the support of finance in new forms, different with respect to those consistent with the extant regulatory/supervisory framework securing stability. This further promotes the spread of financial innovations. Third, there is a swing in ideology, whereby free market visions tend to dominate and become increasingly entrenched. Then, economic theory and the policy debate excessively lean towards stressing the negative consequences of the failure by public intervention in the economy while advocating the benefits of letting the markets free (Leijonhufvud, 2009). This calls for deregulation and liberalisation of the financial system.

The mix of these three factors leads once more to the formation of overly optimistic expectations – as Hyman Minsky (1975) reminded us<sup>3</sup> – and this triggers

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<sup>3</sup> Hyman Minsky's (e.g. Minsky, 1993) distinguishes three borrower types: hedge units (little leveraged and able to repay both their loan interest and principal); speculative units (able to pay interest on their loans but needing highly liquid markets to renew their debt); Ponzi units

excess indebtedness, misallocation of resources and the build-up of a new speculative bubble. At this point, it is only a matter of time and a new major systemic crisis will arrive thus completing this political-economy cycle of finance that, as we described, embraces the path from one structural-breaking systemic financial crisis to the next one. To be sure, such a systemic crisis drawing the political-economy cycle of finance to a close is not a single, stand-alone episode, but rather it is the epilogue of a series of specific crises whose frequency and gravity tend to aggravate as we move on along the sequence. In fact, when the economic system is already operating within a generalised speculative bubble, even the well-meant interventions to stabilise the financial system after the initial instability events are likely, quite paradoxically, to have destabilising effects. This happens because, in some way, the interventions to salvage the imperilled financial intermediaries cover their speculative losses and – unless a new consistent regulatory framework is quickly put in place – this strengthens speculation as the expectation becomes more widespread that also in the future new interventions to cover speculative losses will be offered. Accordingly, stabilisations turn out to be destabilising because, in solving the instability of individual financial intermediaries, it amplifies systemic risk. Otherwise stated, in line with Charles P. Kindleberger (1978), if the Lending of Last Resort (LOLR) is heavily used to bail out financial institutions in a systemic crisis, this will backfire in terms of augmenting exponentially the moral hazard of the financial intermediaries and building the foundations of a new bigger crisis down the line.

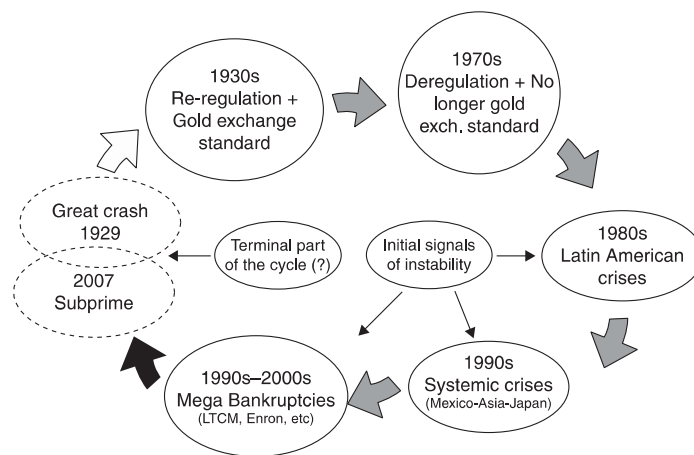
In a sense, financial liberalisation is a driver for economic growth but over time the perils of instability may outweigh those benefits. The history of financial capitalism takes the form of various repeated political-economy cycles. The financial crises of the recent decades will possibly conclude this political-economy cycle of finance originated by the return to stricter regulation of the marketplace as a remedy to the major instability of the 1930s (see fig. 4 and D'Apice and Ferri, 2010). Already in the mid-1930s, countries had developed a consistent regulatory framework to achieve domestic financial stability. Only after World War II was the framework finalised at the international level, with the definition of a new monetary order centred on the US dollar. However, after the abandonment of the gold exchange standard (in August 1971), financial innovation, deregulation and globalisation have progressively generated inconsistencies in the original regulatory framework, providing the background factor of previous crises as well as of the most recent one. By and large, as already stressed, the stabilisation interventions to cope with the crises may themselves turn destabilising when

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(extremely highly leveraged unable to even pay interest on their loans unless the constant increase in the value of their collateral assets allows them to refinance their loans). In Minsky's terms, the subprime borrowers are Ponzi units.

the financial system is operating under an inconsistent regulatory/supervisory framework. A case in point was the rescue in 1998 of the speculative hedge fund Long-Term Capital Management (and also the abrupt drop of the Fed funds rate after the dotcom bubble burst in 2000–01) that, in the absence of re-regulation, was a keystone laid for the Great Crisis that started ten years later in 2007.

**Figure 4. The political-economy cycle of finance**



Source: D'Apice and Ferri (2010).

The triumph of excessively one-sided ideology-driven free market views contributed to building exaggerated trust in the markets and in their ability to self-regulate, motivating policy choices. On the contrary, the progress made by other economics schools – such as Joseph E. Stiglitz and several other scientists moving on that track – in terms of the analysis of the failures of the market was largely disregarded.

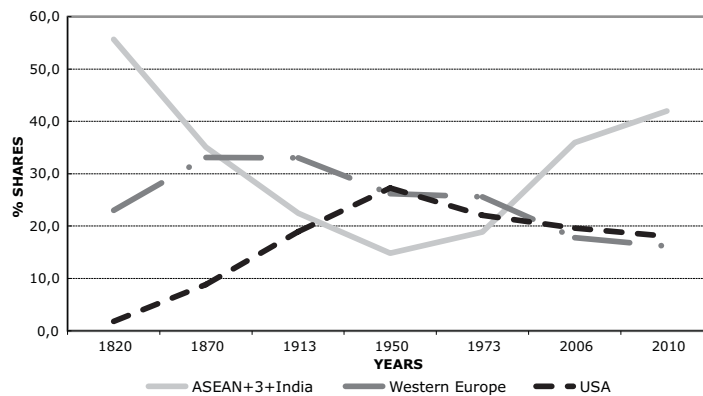
The epochal crisis ignited in 2007 by the turmoil in the subprime mortgage market could suggest this political-economy cycle of finance is ready to come to a close. Indeed, this crisis implies an escalation in terms of its depth and geographical extension and also of the fact that it started at the centre of the financial system and not at its peripheries, as had happened with the previous systemic financial crises of the 1990s and the beginning of the new millennium. The authorities' call for stricter regulation might mark the start of a new cycle. However, re-regulation appears to have lost momentum. In fact, if the pronouncements by the leaders of the G20 in their London meeting of spring 2009 were bold about re-regulation, their statements at the following Pittsburgh meeting in the autumn

of the same year had become much more timid. At the same time, parliamentary actions on both sides of the Atlantic did not seem to move ahead as fast as earlier announced.

Will this mean an even bigger crisis is waiting for us in the future, as the European sovereign debt crisis could suggest? This would be a terrible event also in view of the fact that the public finances of many advanced countries have been exhausted by the interventions to salvage finance from its instability.

There is a further problem. Nowadays, what was once the debate on the decline of Europe has transmuted into one in which, due to the difficulties encountered by the US, the danger of decline refers to the entire Western model. Various considerations ignite this debate but, perhaps, the most striking of all descends from observing that the on-going global crisis distressing the world economy and society originated from global imbalances and excessive indebtedness having the focus in the US (the 2007–09 bout of the crisis) and later on found a second epicentre in the imbalances of Europe (since 2010). Though against that possible sunset of the Western leadership no practical alternative is yet in sight, undoubtedly the world's gravity seems to be moving from West to East, where two countries counting approximately 2.5 billion (plus an additional 0.8 billion in the ASEAN) of the world's 7 billion total have come back to play a strong role.

**Figure 5. Distribution of world GDP shares between 1820 and 2010: Western model vs. Asia**



Source: our calculations on data from Maddison (2007) and updates from IMF data.

Based on Maddison (2007) reconstruction, it is evident from Figure 5 that the Western Model – as represented by Western Europe and the US – gained its world economic leadership only after the Industrial Revolution. Before that, in 1820, the

West approached 25% of world GDP while the sum of the ASEAN + 3 + India<sup>4</sup> accounted for 56%. The ranking was already reversed by 1870 – 42% the West vs. 35 the East and South Asia aggregation – and in 1950 the disparity reached its maximum (close to 54 vs. 15%). However, since then the ASEAN + 3 + India has vividly rebounded. By 1973, at the time of the first oil shock, it approached 19% – with the West at 48% – owing mostly to the economic miracle of Japan and of the Asian Tigers. But the rebound intensified later on, with the inclusion of China and India, bringing the East and South Asia aggregation to 36% (vs. 37% for the sum of Western Europe and the US) in 2006. By 2010, four years into the crisis, the shift had further accelerated putting the two areas, respectively at 42 and 34%. If we were to take at face value the GDP shares projected by Mold (2010), by 2030 the balance between the two areas could go back to a situation more similar to the pre-Industrial Revolution set up than to anything we have seen there since. Indeed, those projections forecast above 55% for the ASEAN + 3 + India – with most of the gain for China – and just about 25% for the sum of Western Europe and the US.

Obviously, Mold's projections could be exaggerated because they are not adjusted for purchasing power parity. Besides, Mold simply projects the past trends to the future neglecting that all economic miracles have ended sooner or later. Furthermore, given the challenges posed by the current organisation of production along the Global Value Chains, the national accounts might overstate the extent of the Western decline as a large fraction of the value added created in the emerging economies still flows back to rich countries' investors. And, even accepting Mold's figures, that would imply a much milder decline of the West in terms of per capita GDP, due to divergent trends in population between the two areas. In spite of these and other possible corrections to its magnitude, the shift from the Western Model to the East and South Asia aggregation is a reality. Shadows of possible decline of the West materialise also if one considers the conditions of public finances through Europe and the US.<sup>5</sup> There would be several other aspects to be pondered, but this West to East shift in the balance of economic power is most likely going to be the single most important determinant around which to reshape the global economic governance.

Specific issues might arise with the above scenario. We will mention just two. The first issue is that of a possibly multipolar global set up, where evidently the East and South Asia aggregation is not a single entity. Still using Mold's 2030

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<sup>4</sup> As it is well known, the ASEAN includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam) while the +3 means China, Japan and Korea.

<sup>5</sup> In his long-run historical perspective Kennedy (1987) argues that the great powers almost invariably decline after fiscal imbalances emerge.

projections, the largest economy would be China (accounting for 28% of the world GDP), followed by the US (14%), and by virtually coupled India and Western Europe (both at about 11%). The other economies would follow at a considerable distance. The apparent implication seems that a complex world economic architecture would be required to ensure smooth global governance. The second issue stems from the fact that some of the countries – most notably China – performing as the main drivers in the West to East shift are structured as hybrid economic systems, with the State playing a pervasive role. Thus, it is not entirely clear how to interpret the functioning of the apparently vibrant market economy in those countries. And, even disregarding that, some of the emerging economic powers do not function as Western democracy, so raising questions about the respect of individual freedom.

## **7. WHY WE NEED STAKEHOLDER FINANCE**

We argued that the Great Crisis had three main causes: i) the global imbalances, particularly between the US and China; ii) the excessively lenient monetary policy by the Federal Reserve; iii) the downside of deregulation/liberalisation of finance. The joint effect of the three factors was that of generating a debt overhang in the US.

When the financial round of the crisis broke out at the beginning of August 2007, and particularly after its escalation with the bankruptcy of Lehman Brothers in September 2008, the global scale contagion caused pervasive government intervention to salvage the endangered banks. Against this background, at the early April 2009 meeting of the G-20, the chief leaders of the world made bold announcements to stiffen regulation in a way to bring back financial stability. However, those promises were largely not fulfilled.

Next we discussed the deep mistakes of the ‘light touch’ regulation of finance through which commercial banks were subjugated to financial market friendly rules. In addition, we claimed that the current re-regulation provides more of the same and does not cater enough for diversity within the banking system.

As regards the slow advancement of the financial re-regulation, we argued that the lack this time of a strong prosecutor such as Ferdinand Pecora in 1933 made the progress of the reform more difficult. In any case, we asserted that a serious re-regulation is the only way out to restore financial stability, as the allegory of the political-economy cycle of finance helped us outline. Appropriate leadership will be needed to secure a reasonably rapid and smooth transition. Lacking that, the sustainability of finance risks being permanently endangered and the stability of the world could also be at stake.

The key role of stakeholder finance emerges at this juncture. Stakeholder finance is a type of finance that doesn’t focus on short-term profit maximisation, as

shareholder finance does. As I argued, shareholder finance brought about a major transformation of the bank business model that implied transforming ‘informed’ credit into ‘commodity’ credit. When credit is treated as a commodity it becomes unsustainable, it loses its function. Indeed, credit cannot be a commodity, because it needs a human relationship to guide it. It is only through that human relationship that appropriate screening and monitoring will be deployed. Stakeholder finance means adopting the traditional bank business model of relationship banking, which implies performing the appropriate screening and monitoring. If banking regulation persists with a mechanic approach to capital and the Risk Weighted Asset (RWA) approach it is impossible to recognize the difference between informed credit and commodity credit and we are in trouble. Thus, stakeholder finance is the way out of this phase of financial capitalism which, as it happened in the 1920s, is a major source of world instability.

### **Abstract**

The paper argues that re-regulating finance while preserving and augmenting its stakeholder-oriented component – as opposed to the shareholder/profit maximizing component – is needed not only to restore the stability of finance, but also to mend the market economy, saving it

Answering the question why financial re-regulation is advancing so slowly, this paper addresses the historical example of re-regulation of the 1930s. It argues that the lack of a strong prosecutor, such as Ferdinand Pecora in 1933, made the progress of the reform more difficult. It asserts that a serious re-regulation is the only way out to restore financial stability. Appropriate leadership will be needed to secure a reasonably rapid and smooth transition. Finally, the paper analyses why we need Stakeholder Finance.

**Key words:** Stakeholder Finance, Sustainable Finance

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