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FINANCE WATCH:
ONE VISION, ONE PROJECT
INVESTING, NOT BETTING

Interview with Thierry Philipponnat
Head of Strategy, Advocacy, Output and Staff, Finance Watch

by Hervé Guez,
Head of Responsible investment research, Mirova

FINANCE WATCH : A VISION, A PROJECT INVESTING, NOT BETTING

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THIERRY PHILIPONNAT

Thierry Philipponnat is in charge of Finance Watch's strategy, advocacy, output and staff.

Thierry started a career in finance in 1985. His 20+ years' experience ranges from trading to devising structured equity products. In 2006, Thierry crossed into the NGO world, campaigning and lobbying on behalf of Amnesty International, with a particular emphasis on the impact of the financial sector on human rights. He was later elected as an Executive Board member of Amnesty International, France. Thierry Philipponnat graduated in Economics from the Institut d'Études Politiques de Paris.

Can you explain briefly how and why Finance Watch was created?

Finance Watch was founded in June 2010 following a call for action from 22 Members of the European Parliament (MEPs), members of the Committee on Economic and Monetary Affairs. As the legislative body for matters of financial reform, this committee has great power. Its members felt, '*Every day we have the financial industry in our office lobbying their interests, it's normal, it's legitimate, and that's life. It's the economic system we're in. But for us, as MEPs, to do our job well, we need to hear a different version of the story – the same story but from the general interest perspective. The story needs, at the same time, to be told by an organisation that will be significantly representative of society and will also have a realistic, professional approach that will allow it to go beyond a general call for reform, in order to make concrete proposals*.'
So that was the call for action of June 2010, which was supported by 5 out of the 7 political groups present in the European Parliament. It was thus a multi-partisan call for action from MEPs from the right-wing, liberals, social democrats and environmentalists alike.
In just 3 months, the call united almost 200 MEPs from widely diverse political backgrounds, which, democratically speaking, gave significant impetus to the whole idea. In the autumn of 2010, a decision was made to try to turn this idea into a reality.

Finance Watch was registered on 30 June 2011 after a 6-month consultation period. In legal terms, it is a Belgian, non-profit, international association; an NGO with two types of member: organisations (such as consumer groups, trade unions, other NGOs, research centres and think tanks) and qualified members, in other words, experts in the financial field.
To become a member of Finance Watch, the sine qua non is that you do not work for the financial industry. This is not a value judgement, as the majority of us came from this industry; it is, rather, a prerequisite for good governance so that the 'boundaries' are clear. It avoids any suspicion of a conflict of interests.

> 'Our mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public, as a counterweight to the private interest lobbying of the financial industry.

Why was an NGO, an association, created as opposed to a body dependent on the Commission or the European Parliament?

I think the main reason is linked to freedom of speech. By definition, when one is a branch of an administrative or legislative authority, there tend to be constraints of an institutional nature that are both legitimate and comprehensible, but that are not entirely compatible with Finance Watch's mission.

Since there are plenty of people with strong technical skills both in the financial industry and in the Commission or Parliament, Finance Watch has 3 goals.
Our goals are:

- to be strongly representative of society
- to have freedom of speech
- to have the technical expertise necessary to take the discussions forward, thanks to a large majority of members coming from a financial background.

Is it not surprising that political representatives in charge of general interest delegate this issue to an NGO?

They are not delegating the issue of general interest, but rather the work of analysis and expression that will develop their thoughts. It's a sign of maturity on behalf of the public entities in Europe, and it's to their credit that they say that, to be able to carry out their work, they need to have balanced and effective debate, with arguments from several sides. In this way, they can weigh the pros and cons and move forward in a balanced manner.
Let's not forget that the work of a lawmaker or a civil servant is terribly difficult: the issues are complex and there is considerable pressure from all sides. Encouraging debate from a general interest point of view is therefore very useful to them.

‘The aim of finance is to bring capital to a productive economy.

Which topics are you working on, or would you like to work on?

So far, our work has essentially been reactive, due to the extremely heavy nature of the agenda of European institutions regarding finance: CRD4,[1] UCITS,[2] rating agencies, shadow banking,[3] bank structures and banking unions.
For all the topics proposed to us, Finance Watch offers an analysis based on the general interest, in order to take a position that we will defend through our lobbying activities. For example, after announcing our position on the implementation of the Basel III Agreement, the CRD4 text, 5 of our 6 key recommendations were transformed into amendments, or propositions for amendments, after 2 weeks of intense discussion at the European Parliament – even if, 8 or 9 months later, much of them had disappeared. In future, we plan to be more proactive and work on fundamental themes that are not always necessarily taken into account by existing regulation or those under development.

What are the main themes that need further analysis?

In our opinion, one essential theme is: *investing*, not *betting*.
For us, the aim of finance is to bring capital to a productive economy and to society. We therefore have to promote a financial industry that allows us to invest, and not to bet. We will be developing this theme with a large number of possible regulations.

Could you explain the distinction you make between ‘investment’ and ‘betting’?

Indeed, this is a very important point because, of course, behind the words one can include very different ideas. For us, ‘investment’ is an act that consists of bringing capital to a productive economy and creating a partnership between the investor and the underlying economic project. With regard to this notion of partnership, whether we win or whether we lose, we do it together. Thus, there is an economic meaning behind investment, which is what society needs.

• (1) The European Commission's legislative proposal of 20th July 2011, entitled CRD4, will integrate into European law the international reform, Basel 3 of 2010. It focuses particularly on demands in terms of banking solvency and on the surveillance of liquidity risk. This text revises the European Directive on the adequacy of own funds (CRD) that came into force in 2007 for the third time. • (2) UCITS: Undertakings for Collective Investment in Transferable Securities. • (3) Shadow financial systems are a series of financial entities such as hedge funds, capital investment firms, corporate banking, credit rating agencies, speculators on raw materials, clearing houses and off-balance-sheet companies.

‘Betting’ is a zero-sum game. If you and I were to bet on the change in the price of the pen you’re holding over the next 10 minutes, one of us would win and the other would lose. Besides you and me, no one else would have been affected by our bet. That is an example of a zero-sum game.
You need to put things into perspective, though, because there is a part of speculation that has an economic and financial use in certain markets at a certain time and to a certain extent. Betting is something that has always existed, and our aim is not to get rid of it. Having said that, when we’re in a financial system where this activity is becoming predominant (and there are examples to prove this) and when intellectual confusion is such that numerous ‘betting-related’ activities are considered as ‘investment’, then there is a problem. It’s not a question of whether it’s good or bad, but it is, nevertheless, useful and necessary to outline the conceptual difference between activities playing a role in the economy and activities of a different nature. As a result, the legislator will be more easily able to tell the difference between investment products and other types of products.

You seem to separate ‘vanilla’ assets (such as equities, bonds and real assets) from products based on derived instruments. Is this the case?

In general terms, yes. If we have only 20 seconds to summarise the position, it is exactly what you have just said. But we all know that there are obvious extreme cases and intermediate cases where the boundaries are more difficult to define.

Going back to the definition of assets; let’s use the simplest one that everyone will understand, that is, holding shares on a secondary market. Would it be right to distinguish ‘high-frequency trading’ products from ‘long-term holding’ products? In other words, if I were to buy some equities on the secondary market, am I financing the real economy regardless of if I hold them for 3 days or 6 months, or am I doing what you consider as betting?

Clearly, on the secondary market, we know very well that the boundaries can sometimes be blurred. Having said that, in order to finance the economy, we need savers who put their savings in equities and bonds. I do not know a better solution than savings that invest in these asset classes.
Beyond that, what is the holding duration that determines when we move from a pure bet to an investment? We all know that it is not an exact science and I wouldn’t pretend to be able to trace the line. One thing that is certain is that we are far from what we could call an investment when the investment horizon is reduced to milliseconds.

‘ Giving investment an economic meaning is what society needs.

Are you referring there to high frequency trading?

Yes. I am convinced that a company has relatively long cycles, probably over some years. I know a lot of asset managers who find equities very frustrating because their expertise is based primarily on their capacity to find a company that can create value in 3 to 5 years.
And yet, though this is a bit of a caricature, we ask them every week if they have beaten their benchmark. This topic is part of a discussion launched by the European Commission on the concept of long-term investment. It’s something that we, as well as the Kay Commission in Great Britain, are working on. There are obviously numerous issues but if, at the end of the day, capital flows are oriented towards equities and bonds (as opposed to products with relative values, secured capital, and so on), we would have won, at least in terms of economic logic.

What do you feel about the Libor manipulations?

We've built a system with conflicts of interests at various levels. There have always been unscrupulous individuals, and there always will be, though I'm not sure that there are more in the finance industry than elsewhere. Today, the ideal solution would be to build a system that discourages this type of behaviour. Indeed, the system should be able to detect it to avoid being vulnerable to unscrupulous traders.
With regard to Libor, the trader is both judge and defendant; judge by stating, for example, that 'I think Libor is X' and, at the same time, defendant since, by determining a level X or Y, his profitability and his profit will be different.
A person who is extremely rigorous and very honest can easily handle these two roles, though it is obvious that the door is wide open to all kinds of manipulation.

Good governance should let no one be both judge and defendant; human beings are who they are, and it always ends up getting out of hand; it happens everywhere. There's a similar sort of situation with regard to the price of electricity, and it's common knowledge that the same applies to oil, gas and probably other indices, just like every time that a system is built on this double role of judge and defendant.

What is your position in the debate about credit rating agencies (creating a European agency, more strict regulations, and so on)?

For us, the creation of a specific agency is really not the answer. Nothing would change and the European authorities are fully aware of this. This project has therefore been put on hold because, apart from the fact that it's too expensive and a rating agency takes about 10 years before it is credible, it simply would not work.
The problem with rating agencies is identical to that of the Libor: confusion of roles. Rating agencies must act as analysts and not judges! To have someone who carries out an analysis, and says, 'I think that...', is not just good, it's vital. And if an analyst's opinion is just something that we can choose whether to accept or ignore, the problem with rating agencies is that they are both 'analysts' and 'judges'.
In fact, as soon as an issuer sees its credit rating downgraded, asset managers (or some of them at least) will no longer be able to buy it because it is there in black and white, that the European Central Bank's rules on refinancing are linked to these rating agencies.

In short, then, would you say that the political authorities ought to 'deconsecrate' the role of credit rating agencies, rather than being outraged by their methods or the quality of their ratings?

Exactly! We commented on this issue during a hearing at the European Parliament and it's a topic that we feel very strongly about. *'Ladies and gentlemen, lawmakers and regulators, take the bull by the horns and start by removing all reference to rating agencies from financial regulations, the CRD[4] and others because, at the end of the day, you are the ones creating these pro-cyclical effects, you are the ones assigning them the role of "judges" when they should only issue opinions.'*

• (4) CRD: European Directive on the adequacy of owned funds, which entered into force as of 2007.

Where do you stand on the debate surrounding the role of agricultural derivatives? It's a recurring debate that comes up with every incident, as was recently the case with the severe drought period in the United States this summer.

We have done a lot of work on this topic. Our opinion is that a certain amount of speculation on the agricultural markets is useful (and what happened in America has reinforced this).
Indeed, for the farmer who wants cover for his production, there is a speculator who will take the opposite position. Studies, both empirical and theoretical, have shown that a level of speculation of 20–30% on the market is of real economic value.
The problem on the agricultural markets today is that the speculation ratio compared to other market uses (speculation or covering agricultural-related financial products) is around 70–80%. Such a level of speculation creates instances of price distortion that have considerable consequences. On these markets, contrary to equity or bond markets, it is the price of the future that will dictate the price of cash.

I can't remember the exact figure with regard to financing agricultural products, but I do know that the financing of commodities in general represents around 500 billion dollars globally. Technically speaking, in market terms, that makes 500 billion dollars of Delta One[5] products that create an upward pressure on commodities.

To come back to our opinion on *investing not betting*, we can clearly see that this money is not going into the productive agricultural economy. This relates to *betting*, not *investing*. A so called agricultural 'investment' product is not an investment, it's a bet.
What is unique about Finance Watch is that we advocate the banning of derivatives related to agriculture (index-based products, Exchange Traded Funds), as we are convinced that the consequences are too dramatic.

> 'The problem with credit rating agencies is that they are both 'analysts' and 'judges' due to inadequate regulations.

In more general terms, why have derived products been developed to such an extent?

Regarding derivatives, there's an ongoing debate about whether they are good or not. For a relevant response, the question needs to be asked differently. Derivatives are effectively only a tool. In and of themselves, tools are neither 'good' nor 'bad'. It all depends on how we use them. The real question, therefore, is to find out why derivatives represent such massive investments around the globe. After having spent a long time devising structured products, I am convinced that the main reason is their low cost of production. The cost of devising these products is far too low. All the trading desks that structure derivatives obtain funding that is far too cheap.
The derivative market relies on an oligopoly of no more than 12 to15 large banks worldwide. The Liikanen[6] report reveals interesting figures, stating that BNP Paribas implicitly controls 50,000 billion Euros-worth of derivatives, Deutsche Bank 60,000, Société Générale 20,000 (and so on) for a notional underlying 700,000 billion dollars worldwide. I remember being in a trading desk that, like any other desks, regularly raised 40 or 50 billion Euros a day on the money market. That was before the crisis. These funds were raised at the rate of the money market (a few basis points above the Libor or Euribor). These activities normally generated 2 to 3 billion Euros of profit with a profitability of 2 to 4% of the amount of financing raised.
Who would have lent 40 or 50 billions to 400 traders, even if highly qualified and organised, if it were not for the name of a big bank behind them? Everyone was willing to lend 40 million Euros at the Libor rate because they knew that there was virtually no credit risk. If one were to lend the same sum to a bank that was not 'too big to fail', the cost of financing would have been 3–6% higher and, in

• (5) Delta One products are derived products whose price evolves in line with the underlying assets. • (6) The Liikanen Commission was established by the European Commission in February 2012 to examine the feasibility of structural reforms aiming to reinforce the stability and efficiency of the European Banking Industry.

this particular case, profitability of a large part of the more speculative activity would, without a doubt, have disappeared overnight.
I therefore believe that the best way to regulate derivatives would essentially be to make sure that entities that sell them finance themselves at a cost that is economically fair.

That brings us to the issue of banking structures. If I've understood correctly, in the debate on separating retail banks and market activities, in your opinion, we would separate 'investment-related' activities from 'betting-related' activities?
As such, the low cost of financing of the 'too big to fail' banks would be available to the real economy and investment. We would need to ensure that this advantage, with its high economic value, does not benefit betting-related activities that should be independent structures?

Yes, absolutely. A bank that's too big to fail benefits, de facto, from an implicit guarantee of the power of government and, therefore, of taxpayers. While it is conceivable that taxpayers and society could support activities that are in the general interest, activities of a different order should be practised freely without reliance on what is effectively a form of subsidy. When we hear it said that 'during the latest crisis, French banks did not cost the taxpayers anything, so a banking reform is not necessary', the reasoning is rather shallow.

In concrete terms, how would you define the boundary between 'investment' activities and 'betting-related' activities within banks?

The boundaries are not always that easy to define. However, I would say that there are basically two types of banking activities.
On the one hand, you have an activity that is directed towards financing liquidity for companies and individuals. On the other hand, you have the financing of assets. A banking business that finances economic flows usually does not create a speculative bubble. However, when money is directed at buying assets, there is always a risk that it contributes to the creation of a bubble, either in trading or in real estate.
Bubbles are a recurring issue that comes back each time credit is too abundant or when there's money creation destined for these activities. Any activity linked to buying assets should therefore be done on 'existing' money.
In asset management, for example, savings (funds) already exist, so there is no creation of money. In a similar fashion, a corporate or investment banking business should focus on money that already exists and not on money creation. The problem with universal banks that have under their roof both retail and money-creation activities, is that the retail activity and the underlying money-creation activity are susceptible to being involved in the purchase of assets. And that creates economic bubbles.

> ‘Above all, we need to separate activities that are investments from those that are bets.

On this very topic, what do you think about the conclusions in the Liikanen report?

At the Liikanen Commission hearing, we argued in favour of the points I've just summarised. I think that the analysis of the Liikanen report, prior to the final proposal, is particularly lucid and relevant. They really go deep into the matter and they deserve a lot of credit for such a tough job.
Nevertheless, the proposals are not up to the same standard as the analysis, in our opinion. First of all, if the separation that they propose in terms of trading activities makes sense, setting the threshold for these activities (that could remain on the banks' balance sheets) at 15% or 25% is not the same thing. In Europe, the large majority of banks fall just under 25%. We therefore get the

impression that this threshold was set with a view to not affect too many people. Furthermore, the line drawn between the two banks seems to us inadequate. More exactly, we would have preferred that real estate loans move over to the other side of the fence, to the trading side.

Today, financial activity is the subject of much attention. After the Liikanen Report, came the recently published Kay Review.[7] What is your opinion on this last report?

Indeed, its analysis largely resembles the one I developed on the subject of investment versus speculation. Although expressed in a slightly different way, our rationales are comparable in that they consist in creating a form of 'partnership' between the investor and the underlying project.
In my opinion, the key point in the Kay Review is that it defends the idea that, in order to achieve the ideal pro-investment situation, one of the key elements, or the key element, is to have measures in place that take into account this idea of close relationships between investors and the project, and the duration of the partnership.
Then the question of the measure of market risk arises. Provided that this measure is a *Value at Risk*, we transform a long-term investment into a daily trading activity. A benchmark, in my opinion, is vital or at least useful, as we need to be judged on certain criteria. However, we need benchmarks to go beyond just weekly performances.
The issue of short-term / long-term measures and the adaptation of these measures is essential if we are to evolve into an asset management business that would give us enough time to do our work of detecting and selecting good projects.

> 'As long as the only way of measuring market risk is Value at Risk, we are turning investment into a daily trading activity.

Is there not a contradiction in the political thinking? On the one hand, indeed, there is a wish for a financial system that will be in the general interest, for the benefit of the real economy and steering savings towards the long term. On the other hand, are all the regulatory measures aiming to reduce risk. However, long-term finance to a certain extent is synonymous with additional risk, don't you think?

I couldn't agree more. During the discussions we have, whether with regulators, lawmakers or the Commission, we try to make them realise that these two objectives, realistically speaking, are not compatible. The stated objectives regarding financial regulation outlined by the elected representatives and the local government officers are, firstly, to finance the real economy and, secondly, to ensure savers do not take on risk.
In the end, you have to admit you've taken a risk, but one that is going to be put to good use for the economy. Put simply, buying shares and bonds responds to this logic. We can't always say, 'Finance the real economy, but don't take any risks.'

At a seminar organised by the European Commission that I went to three weeks ago, several stakeholders were consulted on this matter. I was asked to lead a session and I took the same stance as you, that is: what you're proposing is contradictory, so now you need to choose. I'll even go as far as to say that if you say to an equity fund manager that they have to have a daily liquidity, there are too many constraints. You have to break the taboos and tell yourself that if liquidity were slightly less, it would give portfolio managers the opportunity to take the time to choose assets and manage them in the long term.
But here we're up against huge opposition, even at a political level. I've heard MEPs from across the political spectrum say, 'Yes, but what about consumer protection?!' To which we respond that we need to stop treating consumers and investors like children. They are capable of dealing with the fact that an economic project is not fundamentally liquid and that, by the same logic, financial assets should not always be completely liquid.

• (7) The British economist, John Kay, was commissioned by the Secretary of State for the Department for Business Innovation & Skill to examine activities on the British equity markets and their impact on long-term performance and the governance of companies listed in the United Kingdom.

If there's a real virtue behind liquidity, we will recognise it, but we also need to find a balance and develop products that we'll have the courage to say will be less liquid because it's the only way to steer savings towards long-term investments.

'In order to promote investment and not speculation, we need measures in place that take into account the relationship between the investor and the financed project, as well as the duration of the partnership.

That seems logical to me. We've talked a lot about finance and the real economy, but do you also have an opinion on whether or not finance should take external social and environmental factors into account?

It's not something we have worked on, mainly because we don't have the internal resources to go beyond general statements on the matter. Nevertheless, on the fundamental topic of long-term investment, the first question is, 'How can we turn savings into long-term investments?' and the next step is, 'What is it that we wish to finance in the long term?'
This is where the external social and environmental factors would come in. There are a good number of organisations with real expertise in this matter. They have approached us and we have started working with them to try and pool our know-how. Our contribution concerns the regulatory aspect and the necessary conditions to encourage money to go towards investment, while theirs is to do with driving investment towards the energy transition, and so on.

Thierry Philipponnat, thank you for your time.

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Finance Watch

Making finance serve society

Finance Watch is a public interest association dedicated to making finance work for the good of society. Its members are trade unions, consumer groups, NGOs and civil society organisations which, together, represent several million European citizens.

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