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Achieving growth through traditional finance

Building trust for prosperous sectors and sustainable growth

NFU KEY ISSUES PAPER

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CONTENT

INTRODUCTION 3

SOCIETY NEEDS TRADITIONAL FINANCE 4

IS THE INSURANCE SECTOR AN UNUSED POTENTIAL? 5

THE NEED FOR GOOD REGULATION TO ACHIEVE TRUST 6

STAKEHOLDER FOCUS TO STRENGTHEN TRUST 7

POLICY RECOMMENDATIONS 9

REFERENCES 10

ABOUT NORDIC FINANCIAL UNIONS

Nordic Financial Unions (NFU) is the voice of the employees in the Nordic financial sectors. We are an organisation for co-operation between trade unions in the banking, finance and insurance sectors of the Nordic countries. Through our eight affiliated unions in Denmark, Sweden, Norway, Finland and Iceland we represent 150 000 members – a vast majority of the employees in the Nordic financial sectors. Together, we work for sustainable financial sectors.

Mission

NFU – Nordic Financial Unions is a lobbying organization promoting the interests of Nordic financial trade unions in Europe.

- Through a high level of competence and dialogue we contribute to shaping a sustainable financial sector, fundamental for job creation.
- NFU creates value for the affiliates by acting as a knowledge hub among trade unions in the Nordic financial sectors.

Vision

NFU strives to make the financial sectors prosper in a way that is sustainable for employees, companies, consumers and society.

- This is done through influencing regulation, framework conditions and business strategies that support job creation and economic growth.

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INTRODUCTION

Financial services play a crucial role to secure long term and sustainable growth for societies. The financial sectors provide funding to companies and individuals by acting as intermediaries between those willing to lend and those in need of borrowing, as well as support economic development through providing insurance, pensions, and other financial products. In addition, the financial sectors itself give the economy added value through high innovation and productivity growth, and serving the society with jobs and tax revenues.[1]

In carrying out this role, the financial sectors have a special responsibility towards the society compared to other sectors. If it fails people will suffer, as the financial crisis recently and harshly has shown. NFU's vision is to strive to make the financial sectors prosper in a way that is sustainable for employees, companies, consumers and society. However, developments in the industry and among policymakers challenge this aim and risk the sustainability of the sectors.

Policymakers and the industry should aim for re-boosting the core values of traditional finance. These values embrace the simple idea that finance exist for the society. This means that financial institutions should **balance economic and societal objectives**, such as lending to the so called real economy; have a **local focus to serve its customers** in the best way; aim for **long-term and stable profits**; be **safe and resilient** by having qualitative risk assessments and follow EU and national regulations; and have a **stakeholder approach** in its business models. Many of these characteristics can be found in traditional finance such as retail banking, with local presence and focus, and which takes more factors than only shareholder returns into account.[2]

Today the European Commission looks away from traditional finance as a source of funding when developing legislation supposed to increase investments and thus boosting growth and job creation.[3] Through recent years' regulatory reforms, the European financial sectors have taken major steps towards becoming more resilient and sustainable. Policymakers should make full use of the potential that the reforms have brought along – namely, financial sectors that support economic and job growth on a stable and transparent regulatory foundation.

In addition, the institutions themselves have a large responsibility to carry out and expand their business in a sustainable manner. Only through ensuring a healthy balance between the company's stakeholders can this be done: between shareholders, consumers and employees. In recent years, this triangle has become unbalanced to the disadvantage of the employees - the company's social capital. Sustainability is also about investing in the social capital. Employees are essential for a company's profitmaking and making the necessary risk assessments.

There are several reasons to promote the traditional financial sectors to invest more in the real economy, to boost growth and job creation both within and outside the sectors. Actions must be taken, both by policymakers and the industry. This paper aims to contribute to that discussion.

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SOCIETY NEEDS TRADITIONAL FINANCE

"The economic and financial crisis has affected the ability of the financial sectors to channel funds to the real economy, in particular to long-term investment"[4], the European Commission argues. As a consequence the Commission has launched initiatives to promote new funding alternatives.

The difficulty of small and medium sized enterprises (SMEs) to access finance is used as a main argument for promoting alternative sources of finance, often found in the so-called shadow banking sector. SMEs are indeed crucial for the European economy as they represent around 60% of the employment and contribute significantly to GDP growth.[5] SMEs' importance for the economy is likely to grow in significance. Thanks to digitalization many SMEs are *born globals*: through digital opportunities they reach a global market already from the start.[6] SMEs provide a great potential for Europe, but in order for them to be created and to grow they need capital.

This type of **credit is most often supplied by traditional financial services**, typically provided by banks that have local knowledge and presence thanks to branch offices.[7] And it is hardly a coincidence that the funding to SMEs have fallen at the same time as the banks have had to hold more capital buffers as a consequence of the financial crisis. Against this background, policymakers should ensure a level playing field among all providers of financial funding in order to rebuild consumer confidence.

To promote new funding alternatives is also to promote new kinds of institutions, which to a large extent will be active on international markets. Such institutions could be both multinational giants, such as Google, or fin tech startups engaging in BitCoin or crowdfunding. International competition is a good thing, but the local focus should be kept, irrespective of whether the local is defined as a specific community, a single country or Europe. New institutions will, just like traditional banks, assess SMEs through financial statements and other quantitative measures. However, traditional banks with local branch offices are in addition to quantitative measures able to do **qualitative assessments through their knowledge of the local economic context** and often also the companies themselves.[8] This relationship, ultimately upheld by the bank's employees, is not only a competitive advantage for the bank itself but also key to ensure stability in the financial sectors.

This essential relationship between a financial institution and its customer is one of many reasons for companies and legislators to invest in social capital – i.e. the employees. **The Commission, and other policymakers, should therefore create an agenda to promote finance based on local knowledge and activities that are both sustainable and linked to the society.**

The impact of digitalization in the financial sectors set new frames for how finance is conducted. Key in this is that the core values of traditional finance are still in the frontline, not least in order to create the trust needed to compete with new actors coming from the technology sector.

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IS THE INSURANCE SECTOR AN UNUSED POTENTIAL?

NFU encourages initiatives that focus on how the financial sectors can contribute more and better to society, especially on a long-term time horizon. The insurance sector has an interesting potential in this sense. Pensions and savings are a growth area for insurance companies – and for the future this entails a bigger responsibility than today for them to invest in a sustainable and secure way. In addition, and just as banks, the traditional insurance sector funds SMEs.[9] Moreover, especially life-**insurers, as well as pension funds, have long-term commitments in their business models which make them interesting institutions to finance long-term projects**.[10] Since insurers are long-term investors, such investments can work counter-cyclical. Long-term investors can hold or even buy assets that are temporarily undervalued during an economic downturn and sell assets that are temporarily overvalued during a boom.[11]

Together with mutual funds and endowments these institutions hold assets of 13.8 trillion Euros, which is more than 100% of the EU GDP. These institutions already invest in some infrastructure projects - for example some pension funds have invested directly in large-scale renewable energy projects in recent years.[12] Once again we can see how traditional finance can work to contribute to the growth of the European economy.

However, if policymakers aim to increase the funding from insurers and pension funds it is important to look at transferable risks and what the impact would be for the consumers and pension beneficiaries around Europe. Furthermore, using money from pension funds could risk these assets at the cost of future generations.[13] It is therefore important that before any initiatives are taken by legislators, **an in depth public debate should be made about insurers' and pension funds' contribution in financing infrastructure investments.**

Policymakers should also bear in mind that pension funds and different types of insurance companies do not function in the same way. Some might be more suitable to invest in infrastructure investments and fund SMEs than others.

Pension funds are in addition large investors in banks. These investments should also be seen as an infrastructure investment, since financial services indeed has an infrastructure function for the society. As a consequence, **pension funds investment decisions in banks should have a sustainable investment approach and not contribute to excessive ROE targets.**

THE EUROPEAN COMMISSION SAYS

"Long-term projects, which often require a considerable amount of funds and know-how in their implementation, have intrinsic risks. Insurers and pension funds are more likely to carry the long term financing risk, but not the project and the implementation risk. Closer cooperation between investors and public authorities may help to successfully carry through these projects."[21]

Infrastructure investment is mainly about rail and intelligent traffic management, to low carbon power generation and energy efficiency in buildings and to interconnections in the energy and ICT sectors.[22]

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THE NEED FOR GOOD REGULATION TO ACHIEVE TRUST

In the aftermath of the financial crisis the trust of the sectors has fallen drastically among citizens, consumers and policymakers. The crisis made national politicians and EU Commissioners start a race to regulate the sectors as rapidly and strongly as possible. Ironically, the Commission now argues that it is new regulation which has diminished the sectors' ability to finance the real economy.

As a consequence, a discussion about how to find alternative sources to fund the economy has started. NFU welcomes increased diversification, since it is good both for competitive reasons and in order to spread risks.[14] It would, however, be a paradox, if the Commission's work to regulate the traditional financial sectors leads to the promotion of less regulated parts of financial services. There is a risk that this new approach could lead to new and unforeseen risks building up.

As Finance Watch and others point out: "When designing new regulations, we must not forget that the crisis was indeed a crisis of shadow banking and investment banking, not of traditional commercial banking."[15]

Policymakers should work to ensure that the regulated financial sectors better can contribute to the society than it has during recent years. The regulations adopted have mainly been designed to handle large banks. However, smaller actors, such as saving banks, might have faced disproportional requirements that have forced them to cut costs. The regulations need to be reviewed in the coming years, in order to ensure that the financial system is both sustainable and contributes to the economy. This is also crucial for the insurance sector and pension funds.

Policymakers need to show financial institutions the trust that the regulations have aimed to achieve. The examples in the boxes to the right point to the values of regulated financial sectors. At the same time, financial companies must also act in a way that builds trust among politicians, citizens, consumers and employees. A quick look at the Nordic banks, in the next section, shows that things can be improved.

VOICES ABOUT WELL REGULATED FINANCIAL SECTORS

There are voices saying that the higher capital requirements, the new era of supervision through the banking union, and other regulatory initiatives do not decrease banks' ability to fund the economy – but rather the opposite. Finance Watch argue that the decision to reduce the lending to the real economy is a matter of choice – other activities could be reduced instead.[23]

An article in USA Today states that "Swiss, for instance, are betting that strict regulations making banks stronger will give them a competitive edge, as customers take their business to institutions perceived as safe".[24]

Regulation also makes a difference in the insurance and pension sectors. In a survey of 223 asset managers, pension plans and pension consultants, with combined assets of $13.4 trillion, more than half said that new regulation is a significant driver of innovation. This occurs because regulators are paying special attention to the quality of products, to ensure that they are not too risky and that the product is relevant. In that way, products that are better for society are invented.[25]

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STAKEHOLDER FOCUS TO STRENGTHEN TRUST

The Nordic financial sectors withstood the financial crisis, and are now profitable and among the most well-capitalized in Europe. The six major Nordic banks have together increased their results from 8 382 million Euros to 12 748 between 2011 and 2014.[16] And as can be seen on the next page, dividends are increasing and returns on equity (ROE) are high in a European comparison.

However, this development has had a downside. It has come together with a short-term agenda: cost cutting. **Job losses in the sector have been significant**: the Nordic bank sector employs almost 10 000 less people today than before the crisis.[17] Necessary restructuring within financial institutions can explain parts of this, but in many workplaces fewer people have to do more and finance employees feel the pressure from sales targets and performance measurement systems.

Several reports and surveys warn about the increased stress in the Nordic financial sectors. Research from Norway reveals that finance employees work 15 days extra outside registered working hours.[18] In a Swedish survey from 2013, **95 percent of the respondents felt that the working environment in the bank gets tougher.** 56 percent said that they did not have support from management to handle it.[19] It is clearly the employees who bear the burden of heavy cost cutting and very high revenue targets.

NFU calls upon the Nordic banks to shift their business models to a more long-term approach, where employees are considered as the essential stakeholder they are. If the financial sectors should ever get the trust and the positive attention from policymakers that NFU works for, and which this key issues paper elaborates on, financial institutions must also deserve this trust. Today's overarching aim to please shareholders, best revealed by the focus on high ROE, has put a heavy burden on employees and diminished lending to the real economy. This affects consumers' and society's trust in the industry and makes it harder to achieve growth for the sectors and the economy. The core values of traditional finance need a re-boost.

Note the difference in figure 3, on the next page, of average ROE performance between pure investment banks and universal banks. Universal banks, which include **traditional finance activities such as retail banking, have a much more sustainable ROE development than pure investment banks.** According to the think-tank New Economics Foundation, banks with local focus have both higher and more stable ROE returns in the long run.[20] In addition to this, as figure 4 on the next page shows, banks' ROEs in the pre-crisis bubble before 2008 were between 12 and 17 percent in the Euro area which at the time was in an economic upturn. Then came serious problems. In the economic environment that Europe and the Nordic countries face today, it is reasonable to question if it is sustainable to have ROE averaging almost 14 percent, as figure 5 shows that the major banks have today. **The shareholder focus needs to shift to a more balanced and long-term stakeholder focus, which benefits employees, companies, consumers and the society.**

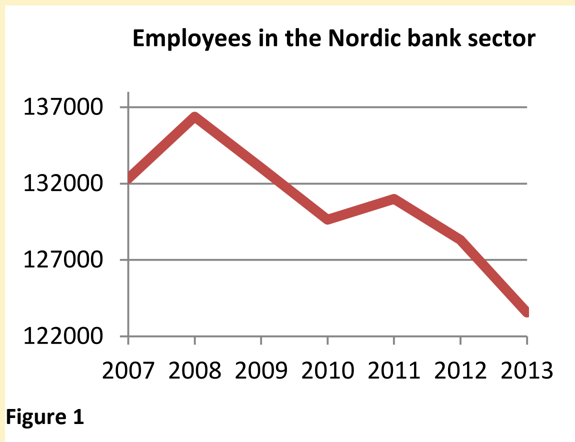

Figure 1

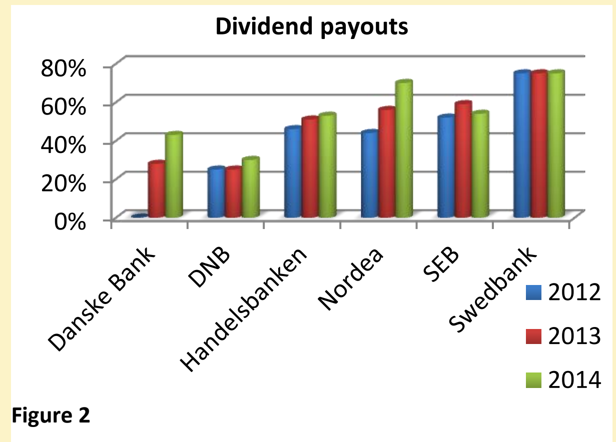

Figure 2

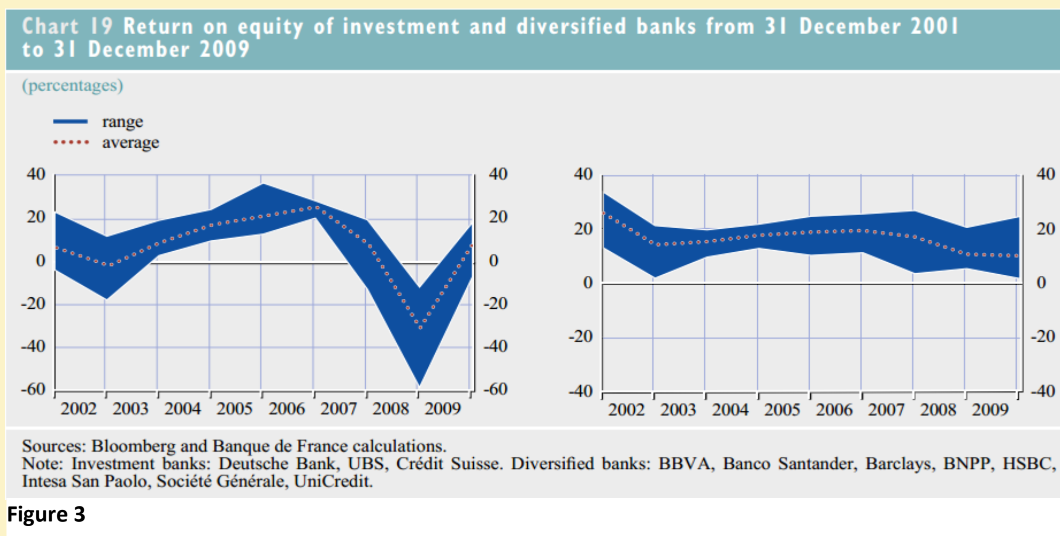

Figure 3

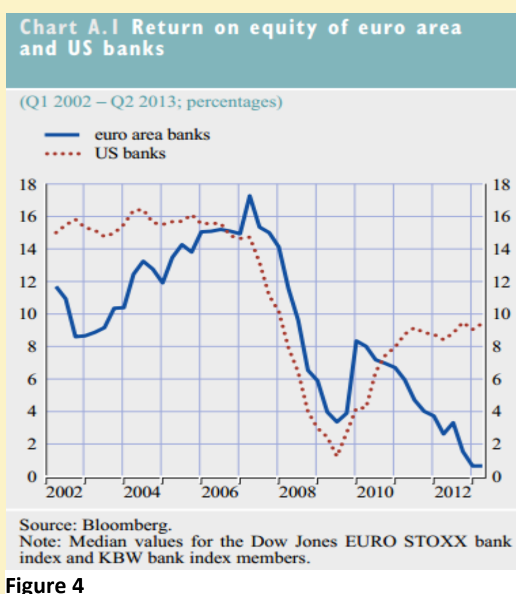

Figure 4

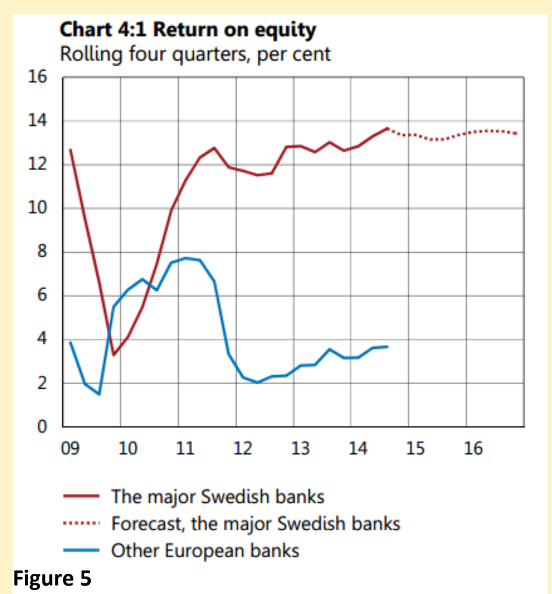

Figure 5

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POLICY RECOMMENDATIONS

This key issues paper argues that traditional finance has a key role to play in contributing to growth in the society. However, both policymakers and financial companies themselves should work more actively to promote the core values of traditional finance to create prosperous sectors and increase the financial sectors' ability to contribute to sustainable growth.

Instead of chasing short-term profits financial companies need to focus on their real task: to provide suitable financial products and lending to individuals and companies also in the long-term. Results need to be balanced in relation to the value it brings to employees, owners, consumers and society. Focus should shift towards good and stable returns, and incentives in the sectors should be more conducive to re-building the trust that has been lost.

Policymakers have a duty to make sure the financial sectors can contribute to long-term growth. The sectors have been regulated in order to prevent and handle future crises. That is good and important, but regulations should not mean that smaller financial companies and local branches are failing, a reduction in lending to the real economy, or that employees will bear the possible costs of regulation.

Instead, policymakers should develop an agenda to ensure that the regulated financial sectors can contribute to growth and be productive. There are countless benefits from traditional finance, some of which have been elaborated in this paper. Therefore, it is crucial that companies embracing the core values of traditional finance can stand strong in the face of ever increasing competition and technological change.

In conclusion, that means:

- **Sustainable finance sectors are ensured by balancing the needs and interests of the consumers, owners and the employees.**
- **Policymakers should develop an agenda for how the regulated financial sectors could further contribute to the real economy, sustainable growth and job creation.**
- **When reviewing current and developing new regulations focus should be on the sustainability of the sectors *and* its ability to contribute to growth.**
- **Employees must be seen as an essential stakeholder, both by policymakers and the industry.**
- **Incentives in the sectors which are conducive to trust should be promoted, for example sustainable business models that focus on activities that provide growth to the society.**

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