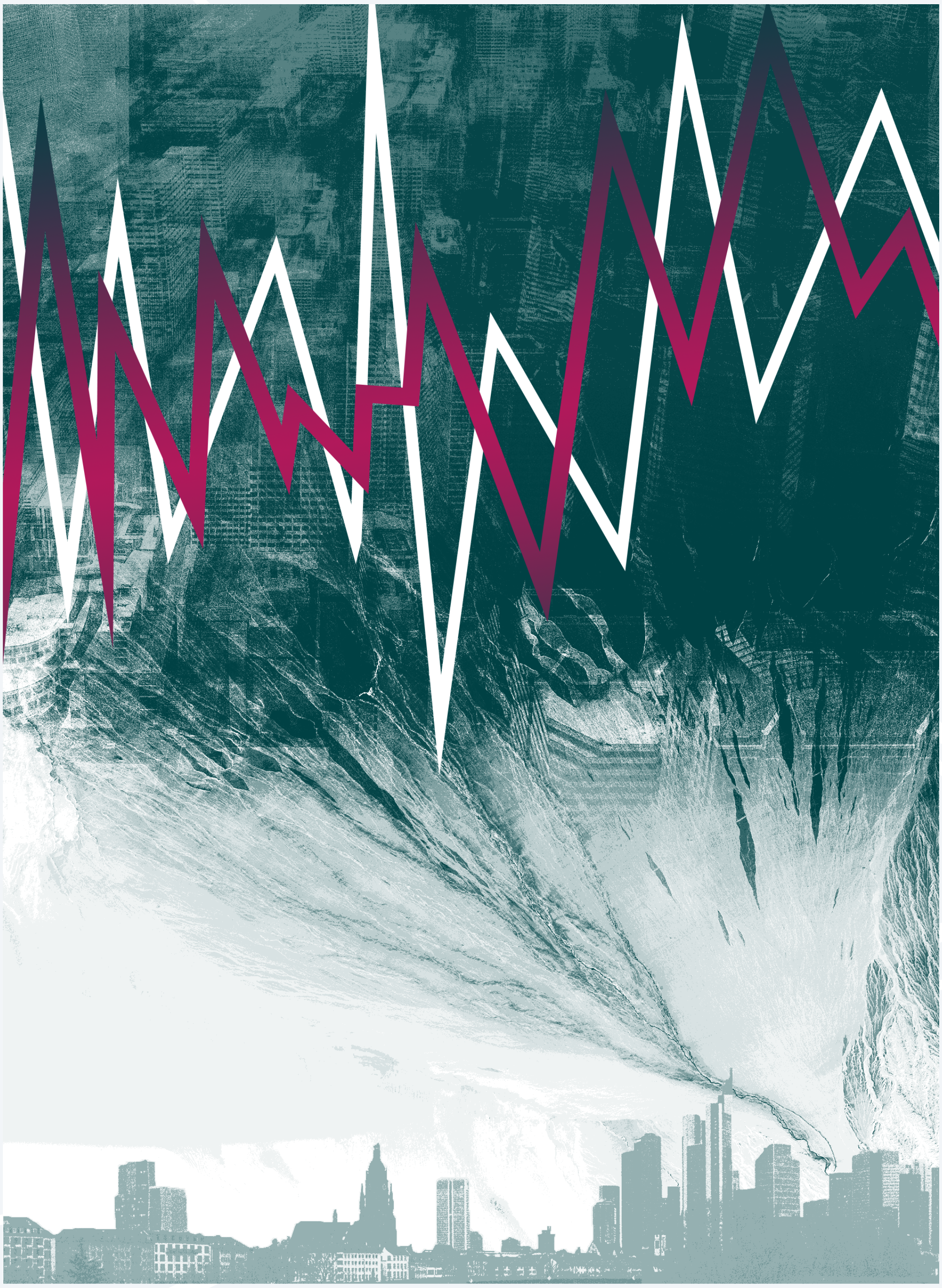
Michael Peters & Magdalena Senn

SHRINK FINANCE, FOR PROSPERITY

Why too much finance harms
the European economy and society

DECEMBER 2021



TRANSFORMATIVE RESPONSES TO THE CRISIS

Michael Peters & Magdalena Senn

SHRINK FINANCE, FOR PROSPERITY

Why too much finance harms
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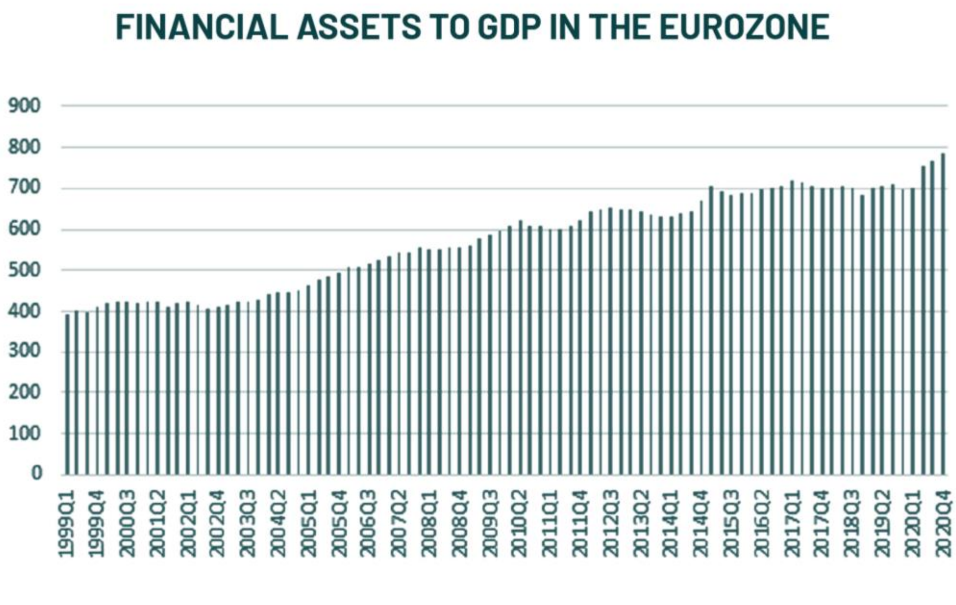
INTRODUCTION

At the beginning of the Covid-19 pandemic in March 2020, both the real economy and financial markets in Europe were severely disturbed. Stock markets plummeted, unemployment surged and governments and central banks stepped in to stabilise the economy. However, stock markets, bond markets and real estate[1] recovered rapidly, reaching all-time highs in summer 2021, as the global number of billionaires increased sharply by 700 to reach a total of more than 2,700.[2] 2020 was the best year for hedge funds[3] while private equity funds went on a historic shopping spree in 2021.[4] Yet at the same time, furlough schemes are still in place in many countries.[5] Many people have suffered massively from the crisis, also financially. Over the course of the pandemic, wealth inequality has increased substantially. At the same time, we have seen an uneven recovery.

The pandemic has highlighted a long-standing puzzle that dates back to the Great Financial Crisis of 2007-2008 and its effects. The discrepancy between a growing financial sector on the one hand, and a stagnating economy and squeezed middle- and lower-income groups, on the other hand, cannot be explained with a short-term development.

In the last 20 years, the financial sector - measured in terms of its total financial assets - has doubled in size relative to annual economic output in the Eurozone. [6] The excessive growth of finance began in the period of liberalisation and deregulation following the end of the Bretton-Woods-System in the 1970s. As a result, finance has grown to play an ever more important role, both economically and politically, and became ever more decoupled from the real economy.

Graph 1



Source: Eurostat, financial balance sheets, total financial assets relative to GDP

This report argues that more finance does not automatically lead to more prosperity. And that today's financial sector in Europe with its excessive size and focus on harmful activities, has the opposite effect. We aim to show that a large share of financial activities is not focused on useful financial services, but instead extracts wealth from the real economy. At the same time, finance has produced severe crises, leading to job losses, rising inequality and redistributing wealth from the bottom to the top of society.

Of course, not all finance is bad. We require financial institutions to provide credit to our economy. . For the financial sectors in the US[7] and the UK, a growing body of research has shown that growth of finance beyond its useful size and roles imposes a burden on society overall. Further growth in this area will tend to create more costs than benefits, reducing prosperity in what has been called a "Finance Curse".[8]

With this report, we aim to provide evidence and make a similar case for the Eurozone. This is crucial at a time when the two biggest European economies, Germany and France, aspire to grow their financial centres by becoming more accommodating to big financial actors.[9]

This report will start by focusing on the oftentimes self-serving nature of finance and its destabilising effects. Then we will show how the financial sector pursues extractive practices and activities aimed at circumventing legislation. Contrary to what the finance lobby likes to argue[10], there is no trade-off between economic prosperity and financial regulation. In fact, we should shrink, refocus and re-regulate finance in order to increase welfare overall. Finally, we present different measures that have the potential to contribute to this aim, but have not been implemented so far.

THE SELF-SERVING NATURE OF FINANCE

To assess whether our current financial sector is useful or damaging, we first turn to one of its core roles, to provide credit to the real economy. Our research finds that, financing the real economy and households does not play a big role in the financial sector's overall activities. Yet the financial sector continues to grow.

In economic theory, a main purpose of banks is to finance investment, providing credit to companies and households.[11] ECB data shows that the share of credit that Eurozone banks provide to non-financial companies and households is relatively low and declining, relative to banks' balance sheets. This share was at 29.9 percent in 2021, down from 33.5 percent in 2000. [12]That means, over 70 percent of banks' activities are not directed to credit for households and the real economy.[13]

IN 2021 EUROZONE BANKS ONLY USED 30% OF THE SUM OF THEIR BALANCE SHEETS TO LEND TO HOUSEHOLDS AND NON-FINANCIAL COMPANIES. WHAT ARE THEY DOING WITH THE REST?

It might surprise that one of banks' supposed main tasks seems plays only a minor role. So what are they actually doing with the rest? We argue that the financial sector is too focused on itself, and involved in all kinds of often harmful activities. We could shrink a large chunk of those activities and thereby benefit the economy and society.

One explanation for the low share of bank credit to the real economy and households lies in the large share of intra-sector transactions in finance: in other words, finance dealing with finance.[14] This entails, once again, a kernel of potentially useful activities such as the use of derivatives to hedge risks, but for a large part it has no benefit for society and, what is worse, can be extractive or destabilising. With (for example) derivatives being used for large-scale speculation, as described below. We call the large share of intra-financial sector activities the 'self-serving nature of finance' and ask: what is the benefit of providing more finance to finance?

Deutsche Bank's giant derivatives business

Take credit provision by Deutsche Bank, for example. According to its annual report 2020, Deutsche Bank lent out 431 billion Euro (worldwide) worth of credit.[15] Putting it in perspective, this is about 13 percent of German GDP.[16] When subtracting credit to households and financial firms, only just above 100 billion Euro or 3 percent of GDP go as credit to the real economy.[17] Nevertheless, credit provision seems like a big part of Deutsche Bank's business model, right? Wrong!

DEUTSCHE BANK'S TOTAL LENDING IN 2020 ACCOUNTS FOR 13 PERCENT OF GERMAN GDP, CREDIT TO THE REAL ECONOMY ONLY FOR 3 PERCENT. ITS TOTAL DERIVATIVES ACCOUNT FOR ROUGHLY 10-TIMES OR 1000 PERCENT OF GERMAN GDP.

If we compare the credit provision in 2020 to the derivative exposure of Deutsche Bank, the true relations become apparent. Deutsche Bank's total outstanding derivatives accumulate to a jaw-dropping 32,000 billion Euro[18], equal to 10-times or 1000 percent of the German GDP. As we will show in more detail below, derivative trading has little to do with the real economy and mostly represents finance dealing with finance.

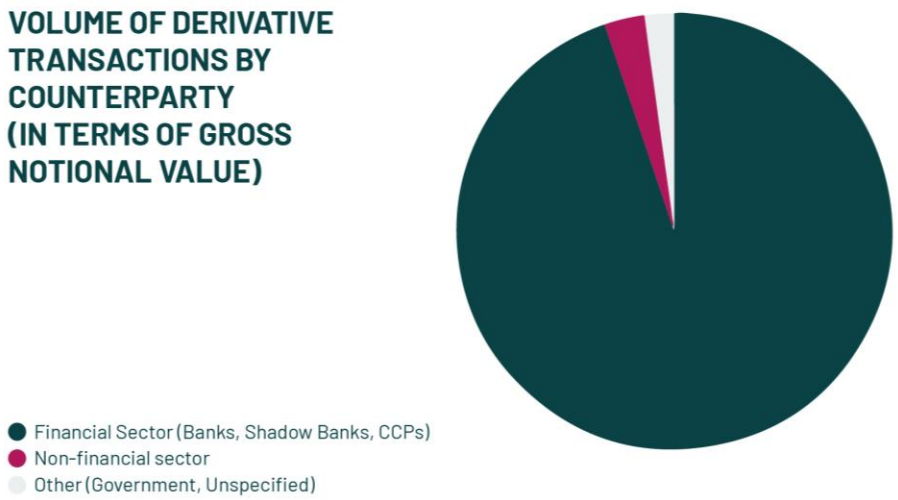
Self-serving derivatives

People commonly justify the use of derivatives by talking about producers, such as farmers who wish to fix a price now for their future harvests. (These kinds of derivatives are called futures.) Yet empirical data casts some doubt on this story, because the world of derivatives has changed profoundly. Fifty years ago most futures contracts did indeed deal with agricultural commodities, but nowadays, most futures are linked to and based on financial instruments and currencies[19]: again, the financial sector is mostly dealing with itself, with no obvious benefit for the real economy, and in many cases potentially inflicting harm.

In the run-up to the Great Financial Crisis, banks supposedly limited their credit risks with credit default swaps (CDS), a kind of derivative. However, CDSs turned into an asset class themselves, used for speculation, and their scale far exceeded the amount of underlying credit they insured[20]. When the mortgage credit bubble burst, this led to a chain reaction and the most severe financial crisis since the Great Depression.

ECB data on derivatives, classified by users,[21] shows that in the EU only 3 percent of volume traded in derivative contracts involve a non-financial company (i.e. the real economy), while 2.2 percent have other actors (such as government or the central bank) as counterparties. The remainder is traded between financial actors, as Graph 3 shows.

Graph 3



The sheer number and diversity of derivatives is also astonishing. In Germany alone, for instance, there were more than 1.5 million different derivatives registered in the first quarter of 2021.[22] By comparison, there are only about 25,000 products in a normal German supermarket.[23] Like the financial sector as a whole, there is a small kernel of the derivatives industry that plays a useful role, while a large part serves potentially harmful purposes. Constraining those dangerous activities would lead to a shrinkage of the financial sector overall, while boosting long-term resilience.

IN THE FIRST QUARTER OF 2021, **MORE THAN 1.5 MILLION DIFFERENT DERIVATIVES** REGISTERED IN GERMANY.

THERE ARE ONLY **25,000 PRODUCTS** IN A NORMAL GERMAN **SUPERMARKET.**

High frequency trading only serving finance

Another prime example of the self-serving focus of finance is high frequency trading. Algorithms are becoming more important in many parts of our society, including in finance. An estimated 80 percent of EU share trading is conducted on the basis of algorithms.[24] High-frequency trading (HFT) is a form of automated trading, where computers using algorithms buy or sell certain financial assets (such as stocks or commodities) based on predefined rules, at high speed. The basic idea is the same as ever: buy low and sell high - faster than other market participants. High frequency trading accounts for 60 percent of all share trading in the EU.[25]

IN 2019 HIGH FREQUENCY TRADING ACCOUNTS FOR 60% OF ALL SHARES TRADED IN THE EUROPEAN UNION.

However, there is a built-in inequality - the required technology and real estate is expensive. In order to compete in HFT, traders require high computing power and location near the relevant stock exchanges. This makes HFT an expensive game that only financial institutions with sufficient funds can participate in. These races can come down to nanoseconds (one billionth of a second).[26]

High-frequency trading is a zero-sum game: it redistributes wealth from society as a whole to a small class of finance professionals. The profits of high-frequency traders come through the exploitation of marginal price differences, at a cost to other market participants, such as pensioners investing for old age. According to a study by the U.K. Financial Conduct Authority, eliminating just one form of high-frequency trading, known as "latency arbitrage," would reduce the cost of trading by 17% and save 5 billion Dollars annually in global equity markets.[27]

HFT has also led to an increased frequency of 'flash crashes', where prices fluctuate violently within minutes, with severe repercussions for financial stability.[28] Algorithmic trading can also exacerbate large price swings, making it harder for some producers and food companies to hedge their risks.[29] HFT is a prime example of the self-serving focus of finance; it serves only very few wealthy financial actors that extract value at the expense of others. If we want to enhance prosperity, we need to end this part of finance.

TOO MUCH FINANCE CREATES INSTABILITY

Financial instability and crises have become a distinct feature of our financial system since the end of the Bretton-Woods System that tightly restricted financial activities internationally in the 1970s. The frequency of financial crises in developed countries was much lower in that period from around 1950-1970, and then much higher in the subsequent period from 1970,[30] which involved decades of financial deregulation.

To some, the Great Financial Crisis of 2007-2008 and its aftermath might seem like a distant memory, but in many ways it still affects our lives today. The starting point was a highly unregulated financial sector that engaged in predatory lending. Then tried covering its risks especially by using derivatives. In a system that delivered great wealth to the financial sector ahead of the crisis. After Lehman Brothers collapsed, other collapsing giant global banks were deemed "too big to fail" and were saved by government bailouts. It was argued that if they had failed it would have dire effects on the real economy, costing even more jobs. Thus, the bill was effectively paid for by all citizens, in a loss of wealth that was vastly greater than any previous winnings for the financial sector. While the financial crisis began in the US and the UK, European banks had also taken excessive risks and contributed significantly to the global financial meltdown.[31]

THE RESCUE OF BANKS FOLLOWING THE GREAT FINANCIAL CRISIS COST THE GERMAN GOVERNMENT 70 BILLION EUROS, BUT THIS WAS JUST A SUBSET OF THE OVERALL COSTS.

In Germany, the direct cost of rescuing banks following the Great Financial Crisis was at least 70 billion Euros,[32] while in Ireland they cost at least 41.7 billion Euros.[33] The decisions about those bailouts were often opaque and were taken without real parliamentary involvement. In the course of bank rescues during the Great Financial Crisis, banks in the EU received 1.6 trillion Euros in state aid.[34] These direct costs were just a subset of the overall costs of the crisis, which mostly came in the form of lost economic output, and high unemployment rates. The renowned central banker Andrew Haldane estimated the global cost of this crisis at 60 to 200 trillion USD.[35]

When companies engage in risky business strategies, the risks can pay off and reward them, or they fail and take the losses. This basic market mechanism of risk and return was suspended in 2008. While gains were privatised, losses were socialised; they were borne by the public. This created a moral hazard problem. Banks were not punished for their behaviour, but rewarded through bailouts. In the future, why should financial actors take less risk, if they can expect to be bailed out again? This effective blackmail potential by the financial sector persists to this day – and has only become worse.

One of the key learnings from 2008 was that the leverage in the financial system should be reduced. Financial actors use borrowed money to 'lever' (increase) the payoff of their investments. However, leverage multiplies both potential wins and losses.[36] If banks know they do not have to bear the losses, they will over-leverage. This has been impressively described in the book "The Bankers new clothes" where the authors show how financial institutions use substantially higher leverage than any other business.[37] A solution to this problem is requiring financial institutions to hold more equity capital - this should act as a cushion to absorb losses.[38]

Box 1: Archegos and leveraged finance

Archegos provides a recent example of how leverage remains a serious problem in destabilising the financial sector and what role derivatives play. After pleading guilty for insider trading in 2012,[39] the fund manager Bill Hwang converted his hedge fund Tiger Asia Management into a private family office called Archegos, to benefit from (even) looser scrutiny and regulation under US law.[40] Hwang invested with a leverage of 1 to 7.[41] This means that for every dollar invested, banks lent him another seven. However, instead of directly investing in assets, Hwang bought derivatives on some shares that allowed him to hide his exposures from the banks involved: Credit Suisse, Deutsche Bank and a host of others.[42] The derivative products would deliver high returns if asset prices rose – but they declined instead. Archegos rapidly became insolvent, inflicting $10 billion of losses to the banks.[43] A report found "deficiencies in [Credit Suisse's] risk culture" that contributed to the default.[44] This shows how disruptive derivatives can be, especially when they are financed with debt to a large extent. While it did not provoke a wider contagion due to its relatively small size. The Archegos case shows how vulnerable the stability of our financial system remains.

There have been attempts in Europe and elsewhere to regulate banks to ensure that taxpayer money would never again be used to save banks. This promise, however, has not been fulfilled and public bailouts have continued.[45] The German public bank Nord LB was bailed out as recently as 2019,[46] the Italian Banca Monte dei Paschi di Siena in 2017.[47] Many of those that have not collapsed continue to take enormous risks backstopped by the prospect of bailouts.

Even though the regulatory push after the Great Financial Crisis has stabilised some of the banking sector, finance has found a way to circumvent regulation. Today, most risks are concentrated in the unregulated shadow banking sector.

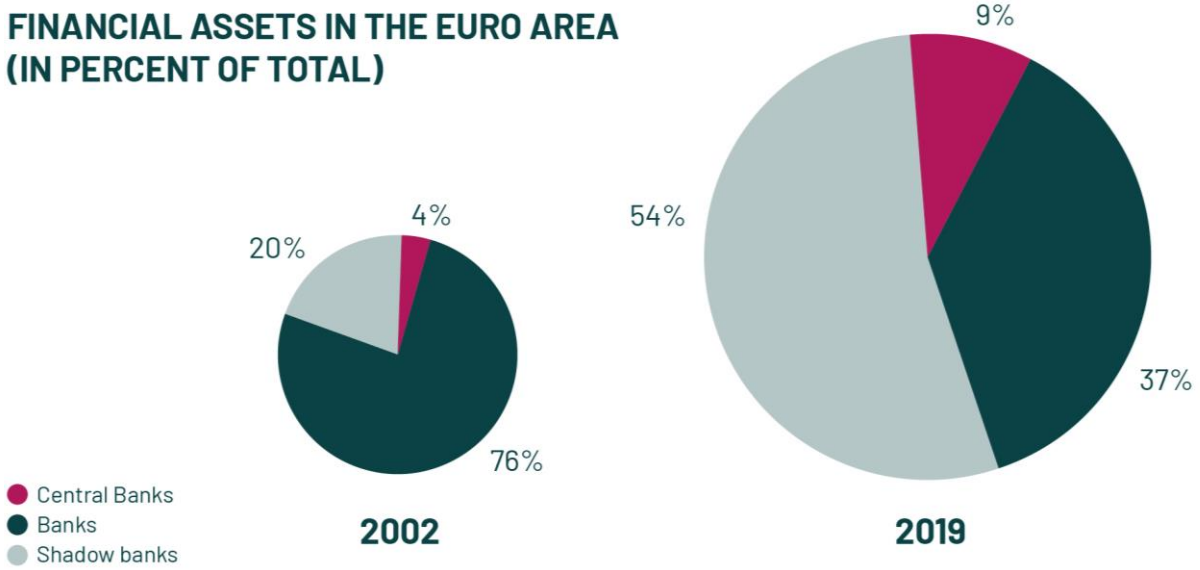
Risks looming in the shadows

After the global financial crisis, the banking sector became subject to (somewhat) stricter rules. As a result, more and more financial activity has moved to the shadow banking system, where regulation is much lighter. Shadow banking is a collective term for financial institutions that act like banks - they can provide credit to other actors, but are not regulated like them, or subject to less strict capital requirements, which allows them to take on greater leverage.

Shadow banks include diverse actors such as money market funds, hedge funds, investment banks or private equity funds. These institutions, unlike banks, are not directly connected to central banks and do not have their automatic backing during financial crises. They are prone to greater risk-taking than would be allowed in the regulated system.

Shadow banks already played a major role in the crisis around 2008 - but they play a much greater role now, as Graph 4 shows, the share of financial assets held by the shadow banking sector in the Eurozone has risen from 20 percent in 2002 to nearly 55 percent in 2019.[48]

Graph 4



Source: FSB (2020), Global Monitoring Report on Non-Bank Financial Intermediation, 16.12.2020, own representation

This clearly poses risks to financial stability, and the potential for major public bailouts to avoid a collapse of the entire financial system. The financial sector continues to hold taxpayers hostage. We saw a small case of this during the financial turmoil in March 2020, when central banks again stepped in as the lender of last resort to stabilise the financial system, benefitting shadow banks (See box 3).[49]

Central banks' quantitative easing has supported the shadow banking sector, which relies strongly on repurchasing agreements (or „Repor"), which „have enabled the growth of shadow banking and was at the very heart of the global financial crisis of 2008."[50]

Box 2: Repurchase agreements (REPOs)

In the financial market, repos or repurchase agreements refer to sales of securities against liquidity in which a repurchase in the future is agreed at the same time. On a certain date in the future, securities of the same type are sold back at a fixed price. From an economic point of view, this is a loan that is collateralized by the securities.[51]

According to experts, to curb these risks, we need to regulate and massively shrink the shadow banking sector:[52] once again, to shrink finance, for prosperity.

It is crucial to recognise that the effect of financial crises goes beyond the direct economic impact.

The insecurity that people face in financial crises has polarised voters and benefited the extreme right, in line with the historical trend: one study of financial crises over 140 years has shown that extreme right parties increase their share of votes by 30% after financial crises.[57] Given that the financial sector in its current form takes too much risk and represents a source of recurring crises, we argue that it damages democracy. If we want to reduce these risks for the general public, we need more than just a shrinking of the individual too-big-to-fail institutions. The only way to do this is to limit debt-financed high risk transactions and thus also to shrink the shadow banking sector as a whole. [58]

Box 3: The COVID-19 financial crisis

The rapid spread of the COVID-19 virus caused stock markets to plummet in March 2020. By March 23, global stock markets had lost US$ 26 trillion in value.[53] Many investors took refuge in so-called safe havens, such as cash. Again, shadow banks were the first in trouble. To pay off the exiting investors, money market funds sold their safest investment products - government bonds. Hedge funds had placed massively leveraged bets on price developments in the bond market, which went awry. The shadow banking sector relies heavily on government bonds as collateral and as the bonds fell, shadow banking actors were in serious trouble. While government bonds were previously considered "as good as cash", March 2020 proved that this only applies in times of stable financial markets. March 2020 showed how strong the linkage between shadow banks, banks and the real economy is, as well as the resulting contagion risk. To prevent a general collapse of the financial and economic system, central banks once again had to intervene.

The ECB announced the Pandemic Emergency Purchase Programme (PEPP): within one year, government and corporate bonds worth approximately 1.85 trillion Euros were to be purchased.[54] This halted the declines. The emergency programs in the wake of the Corona pandemic dwarfed even the measures taken in 2008. For example, the ECB's balance sheet grew by 813 billion euros during the financial crisis from 2007 to 2010, but by 2261 billion in 2021 between February and December alone.[55] As in 2008, this led to a nationalisation of market risk and the socialisation of private losses, from which financial market players profited enormously: they were shielded from the risks they had profitably taken. Hedge funds amplified the distortions in US government bond markets and yet they ultimately profited from the expansionary monetary policy.[56]

A STUDY OF FINANCIAL CRISES OVER 140 YEARS HAS SHOWN THAT EXTREME RIGHT PARTIES INCREASE THEIR SHARE OF VOTES BY 30 PERCENT AFTER FINANCIAL CRISES.

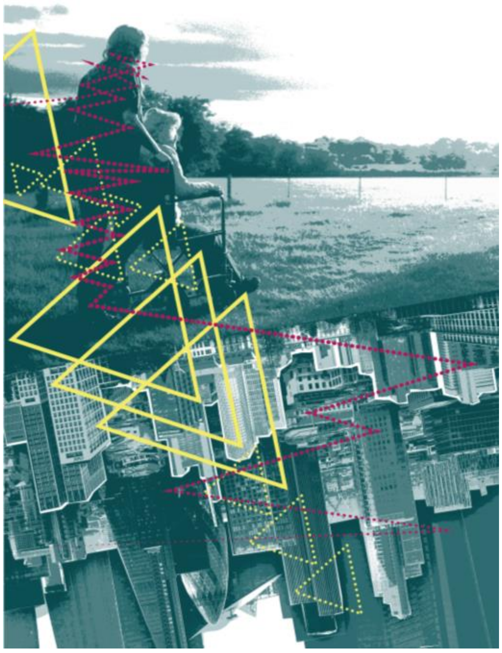
WEALTH EXTRACTION INSTEAD OF WEALTH CREATION

The period of financial deregulation that started in the 1970s has fundamentally changed the relationships between different actors in our economy. Finance got to play an ever larger and more dominant role, a process that is often called *financialisation*. This has been defined as "a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production."[59] Financialisation shifted the role of the financial sector away from supporting economic activities by means of financial services towards extracting wealth from the economy in unproductive ways.

That extraction involves practices such as shifting companies' financial affairs into tax havens (and thus extract from taxpayers,) loading companies with debt to maximise short-term rewards, with risks backstopped by taxpayers, or financial actors buying up many companies in a sector to build monopoly power. These activities are not only unproductive: they are harmful, and reduce prosperity.

Private equity doesn't care

The private equity sector gives a striking example of how financial players can extract profits from other parts of the economy. Private equity firms' business model entails buying companies, restructuring them over the course of typically five to seven years, then selling them for a profit. In the course of the restructuring, private equity firms use a range of financial tools to squeeze profits out of the acquired company.[60] In a recently published study we extensively show these practices in the care home sector in Europe.[61]



For example, private equity firms use large amounts of borrowed money to buy companies. The debt from these operations is then often transferred to the acquired company itself. The amount of debt taken out (from PE funds and external banks) can exceed the capacities of firms and can threaten their long term viability. The debt levels can be further aggravated by high interest rates on intra group loans. The proceeds of the borrowing are often paid straight to the private equity owners and investors, rather than invested in the business to help it cope with higher debt levels.

When this type of financial trickery meets a sector like care, it can be very damaging. It is common practice for private equity firms to sell off a care home company's real estate, then lease it back to the targeted company at high rental rates. The proceeds of the sale may be passed to the private equity owners, and the company providing care is left to cope with paying the high rental costs. As a result, private equity companies frequently reach double digit profits while both the working conditions and the quality of the services provided decline.[62] On top of that, they often pay little to no taxes on their profits, especially if they operate parts of their business in tax havens.

Private equity is a drastic example of how finance systematically forces its way into the real economy or even into public sectors such as elderly care. While private equity firms claim to realise these profits primarily for others like pension funds and family offices, some scholars criticise their business for being a "wealth transfer from several hundred million pension scheme members to a few thousand people working in private equity".[63] Private equity usually extracts high fees for their services – typically six to seven percent of the value of the underlying investment, each year[64], thus making both external investors *and* target companies pay the bill for their profits. This is a clear example of the financial sector extracting wealth for those who are already wealthy, instead of creating value for society. Reining in private equity's excesses would improve care and boost prosperity, society-wide.

Building monopoly power

The effects of financialisation are also obvious in the field of mergers and acquisitions (M&A). The M&A part of the financial sector, often located in investment banking divisions, has been instrumental in helping initiate and push forward waves of profitable "dealmaking" or mergers to assemble companies into bigger firms, whose end result is nearly always to increase monopolisation and market concentration, with multiple negative consequences.[65] In the financial sector, the best-known outcomes of these mergers are the too-big-to-fail banks, which are, as already discussed, able to use their power to hold whole economies hostage in times of crisis, with dangerous political and economic effects.

Another important part of the financial sector again involves private equity firms, which often pursue "roll-ups" that involve using their preferred access to finance to buy up a number of smaller firms and then assembling them into larger more dominant companies with more market power – and this provides a major additional spur to monopolisation in our economies.[66] Large payments processors such as Visa or Mastercard provide a third example of how finance drives monopoly. These financial firms' control over payment flows enables them to extract monopoly rents from all manner of businesses, due to their dominant position in the market.[67]

A major wave of new anti-monopoly thinking is now emerging in the US (and to a lesser extent in Europe[68]) which provides the potential for a range of powerful new approaches. Those would also have the effect of shrinking finance, for the sake of a more prosperous economy and stronger democracy.

Dividends and share buybacks at the expense of people and planet

Other examples of wealth extraction can be found in publicly listed companies. Companies can use profits to: i) finance new investments, ii) pay shareholders through dividends or share buybacks, iii) add them to the companies' reserves, or iv) improve benefits for their employees.

In the era of financialisation, however, listed companies have come under pressure to pay out higher shares of their profits to their shareholders, at the expense of other stakeholders. For corporations in the US[69] and UK[70], studies have already shown that with increasing financialisation, a higher share of profits has been paid out in the form of dividends and share buybacks. Recent studies by Oxfam France, [71] Oxfam Germany and Finanzwende[72] confirm this trend for France and Germany. For example, almost a quarter of the French index CAC 40 paid more dividends than they made profits between 2009-2018: an astonishing corporate strategy where shareholders are effectively "devouring" the companies they own.[73] The companies listed on the German stock index (DAX), dividend payments rose significantly faster than profits in the period from 2009 to 2020.[74] In the US, banks were even more willing to pay out dividends than non-financial firms in times where they didn't make profits.[75]

ALMOST 25 PERCENT OF THE FRENCH INDEX CAC 40 PAID MORE DIVIDENDS THAN THEY MADE PROFITS BETWEEN 2009-2018.

This highlights the trend that wealth created in the real economy is being extracted by financial investors. At the same time, companies are not investing sufficiently in the socio-ecological transition. We argue that we need to shrink the financial sector in ways that limit its power and curb its ability to extract wealth created elsewhere in the economy.

Mis-selling financial products

The extraction of wealth by the financial sector also takes place in the form of mis-selling of unsuitable, overpriced, overly complex or overly risky financial products to firms or private consumers, which have damaged or even bankrupted many firms. In a recent case, Deutsche Bank has allegedly sold risky - thus more profitable - foreign exchange derivatives to the Spanish winemaker J. García Carrión (JGC) which it promoted as cheaper than a more suitable exchange rate insurance.[76] Deutsche Bank likely violated suitability rules supposed to protect companies and consumers from being sold overly complex financial products. The derivatives would have helped JGC if exchange rates had remained stable, but strong fluctuations led to painful losses. In June 2021, Deutsche Bank paid 10 million Euros to JGC to settle the dispute,[77] and two senior Deutsche Bank managers left the company.[78]

DEUTSCHE BANK PAID 10 MILLION EUROS TO SETTLE A CASE WHERE IT SUPPOSEDLY MIS-SOLD COMPLEX DERIVATIVES TO A SPANISH WINEMAKER

Separately, Deutsche Bank was sued for 500 million Euros in damages by the Spanish hotel group Palladium, also for allegedly having sold it risky and unsuitable derivatives. [79] Similar cases involving BNP Paribas[80] and Goldman Sachs[81] show that mis-selling of complex financial products is not an isolated problem.

Retail clients also often suffer from banks mis-selling them financial products. Investment certificates are one example. Here, investors do not invest directly in an asset (such as a company's shares), but bet on a specific development such as the increase of the asset's price during a fixed term. At the end of the term, the amount which is repaid depends on whether the bet was successful or not.[82] The risks are often considerable and investors have to make qualified guesses about future development of specific values and rates. If the issuer of a certificate goes bankrupt before the end of the term, there is even the threat of total loss.[83] In most European countries, the sale of certificates to retail clients is prohibited,[84] but in Germany it is not.[85]

While buyers of certificates in Germany might often be unable to understand the products, this lack of transparency allows banks to hide costs. On top of this, certificates often imply a lopsided gamble: win and loss opportunities are distributed unequally to the benefit of the bank.[86] Both the high cost and the skewed financial opportunities mean that the bank extracts wealth from consumers. Why would any retail client want such disadvantageous financial products? The answer is simple: they don't. Banks push these products in local marketing drives. Experts argue that such products are so detrimental for consumers that they should simply be banned.[87] This would wipe out asset classes that only benefit banks, and would help shrink the harmful parts of finance.

Costly distribution structures

Finance is getting more expensive, in a time when digital services should be making it cheaper. In Germany, the aggregate cost of financial intermediation has steadily increased from below 2% of GDP at the beginning of the 1950s to around 6% in the 2000s,[88] and the individual cost for financial intermediation (unit cost) has not declined.[89] Similar developments have taken place in other European countries in the post-war period.

THE UNIT COST OF FINANCIAL SERVICES HAS NOT SIGNIFICANTLY CHANGED BETWEEN 2007 AND 1950 DESPITE TECHNOLOGICAL PROGRESS

The continuously high unit costs of financial services, despite huge technological progress, suggest that the financial sector has been able to appropriate productivity gains for itself, and for senior staff,[90] instead of passing these gains on to clients or to other stakeholders. Imagine if internet providers did not reduce the price for comparable data volumes since the 1990s, even while it became much cheaper to connect: we would soon argue that internet providers' economic power had become a burden to the economy. In a functioning market with a level playing field, competition should lead to lower costs and better value for money. This is a clear indication of excessive market power, and corrupted competition.[91]

In Germany, nearly 300 000 persons work in the distribution of financial products such as insurance or mortgages[92] – almost as many as those working for the police (June 2019).[93] This huge workforce directly raises costs and affects customers' financial returns. According to reports, the German savings banks (Sparkassen) had commission surpluses of 8.5 billion euros in 2020. [94]

AROUND 290,000 PERSONS WORKED IN THE DISTRIBUTION OF FINANCIAL SERVICES IN GERMANY IN OCTOBER 2021

COMPARED TO 333,600 WORKING FOR THE POLICE

On top of this, commission-based distribution and advice suffers from severe conflicts of interest, leading to frequent mis-selling cases where people end up buying products that are most lucrative for the intermediary, and not for themselves. One study found that misguided financial contracts costed German consumers more than 160 billion Euros between 2001 and 2010.[95] If independent financial advice were to replace the commission-based sales that are common today, many nonsensical or overpriced financial products would no longer be sold, according to consumer advocates. Customers would have to pay less and would receive truly independent advice. The financial sector would shrink.

Finance increases inequality

The financial sector in its current form worsens inequality, both in good times and during crises. For example, rich people tend to get better financial advice and are offered better financial products than poor people, who tend to rely on conflicted commission-based advice.[96]

Rich people also get higher returns on their investments than less fortunate parts of the population. According to Thomas Piketty, big wealth gets average returns of up to seven percent annually, while smaller-scale wealth grows by only three percent or so.[97]

In times of crisis, public bailout of banks and other struggling companies tend to benefit wealthy citizens who own companies or shares (or work in the financial sector).[98] Poorer individuals, bearing a larger tax burden relative to their income, end up paying a far higher share of bailouts. They also suffer more from cuts public spending programmes that often take place during crises, as we saw in many countries during the Great Financial Crisis.[99]

The financial sector also affects inequality via wages. People working in the financial sector in the Eurozone received the highest gross salaries of all economic activities in 2018, stretching the top income scale.[100] Deutsche Bank, with the largest number of high earners of all banks in Europe, had 684 employees earning one million Euros or more in fixed and variable remuneration in 2020.[101] Frequently, bonuses were paid in years when the bank was making losses.[102]

684 EMPLOYEES AT DEUTSCHE BANK EARNED MORE THAN 1 MILLION EUROS IN 2020

It might surprise somehow actors like Deutsche Bank can afford so many high earners, yet also complain about low interest rates, supposedly high capital requirements, or contributions to European deposit insurance.[103]

It is not just in private banks where there is an issue. In Germany, the CEOs of local public savings banks frequently received pay awards of over 1 million Euros.[104] These are banks that emphasise being rooted locally and supporting the real economy[105] – they are even obliged by law to serve the common good, not the private interests of top staff.

Financing the climate crisis

Banks, insurance companies and asset managers take a large number of investment decisions every day. Those decisions will shape our society and economy in future. In the five years after the Paris Agreement in 2015, the 24 largest European banks have poured almost one trillion dollars into fossil energy companies and projects,[106] transforming natural capital into financial capital and undermining the future of the planet in pursuit of short-term gains. The international energy agency (IEA) has stated that no further investments in fossil fuel exploitation are possible if we want to reach net-zero emissions by 2050 and limit global heating to 1.5°C.[107]

However, the financial sector's actions at this point also endanger financial stability. Banks are funding projects that, to a large extent, won't amortise before they have to shut down. Such fossil assets risk creating so-called stranded assets in the balance sheets of banks and other financial actors.

This way, as the ECB noted in 2019, the banks are creating (and currently profiting from) climate-related financial stability risks.[108] These could cause severe financial crises which might end up (once again) hurting poorer communities the most.

BETWEEN 2015 AND 2020, THE 24 LARGEST EUROPEAN BANKS HAVE POURED ALMOST ONE TRILLION DOLLARS INTO FOSSIL COMPANIES AND PROJECTS.

As part of shrinking and refocusing the financial sector for the benefit of the planet and society, we must end its support of the fossil industry, and shift financing from environmentally damaging activities to those that enable sustainable long-term prosperity.

CIRCUMVENTING REGULATION

Laws are based on the principle that everyone should be treated equally. Yet under intense lobbying pressure, legislators often allow exemptions or loopholes in the law to benefit powerful groups. As everyone knows, our financial sector is full of such holes. In the financial system, it often pays to know the rules, to try and find ways to break or circumvent them.

Financial actors who can afford a large number of consultants can create complex structures only aimed at exploiting loopholes and circumventing the law. (Very often, powerful consulting firms consult *both* the government on creating legislation, *and* financial actors on how to circumvent those same laws and rules.) There are large parts of the financial sector that only exist to find ways to circumvent existing rules and regulations, whether by reducing a corporation's tax rate near zero, trading shares to receive illegal tax refunds, or setting up a chain of companies to shield assets. This is a part of finance only profits some and directly burdens the society. This not only leads to a redistribution from the bottom to the top, but is also wealth reducing because creative minds use their knowledge for purely redistributive financial market activities instead of wealth-creating activities. Once again, our societies and economies would be better off if we shrunk these parts of the financial sector.

Illegal and illicit activities

The German state has lost at least 38 billion Euros through illegal share deals called "cum-cum" or "cum-ex" trades.[109] Globally the loss is estimated at 150 billion Euros.[110] In CumEx, criminals exploited the financial system by trading shares around dividend payment dates to receive multiple tax refunds for a tax paid only once, or refunds to which they were not entitled at all. For the scam to work, very large volumes of shares had to be traded, inflating the financial system and delivering major fees to financial actors.

THE GERMAN STATE HAS LOST AT LEAST 38 BILLION EUROS THROUGH ILLEGAL SHARE DEALS CALLED "CUM-CUM" OR "CUM-EX". GLOBALLY THE LOSS IS ESTIMATED AT 150 BILLION EUROS.

Banks also play a crucial role facilitating tax avoidance by wealthy individuals and multinational corporations. The Panama, Paradise and Pandora Papers have shown that banks may for example connect clients with firms such as Mossack Fonseca, which then create shell companies for them.[111] Fifteen German banks were mentioned in the Panama Papers alone - although they deny breaking the law.[112] Others had to pay fines in the millions after the German state bought a tax CD with tax information, for helping their clients set up shell companies. Similarly, the Big Four auditors, PwC, KPMG, Deloitte and EY, help their clients with their tax "optimisation".[113] The LuxLeaks papers, published in 2014 and implicating mainly PwC, showed dramatically how auditors regularly managed to reduce corporation taxes to below one per cent in Luxembourg.[114] In many cases, such structures are not obviously illegal – though that obviously does not mean that they are not harmful to the rest of society. It remains to be seen how effective the new global minimum tax will be at preventing such lopsided tax structures.

In 2018, the renowned economist Gabriel Zucman published a study, stating that overall 40 percent of profits by multinational corporations are shifted to tax havens.[115] In 2015 alone over 540 billion US Dollars were moved from OECD countries to seven tax havens, including Ireland, some Caribbean countries, Singapore, Switzerland and the Netherlands. Such models deprive governments of much-needed revenue. The large losses are not possible without the expertise and know-how of global banks and law and accounting firms. Parts of finance are a driving force in helping rich individuals and corporations to deprive our communities of their fair share in taxes and thereby harm the common good. Reducing the scale of these activities would make us all better off.

Finance helps organized crime

The recent publication of the FinCEN-Files showed the pivotal role that European banks play in money laundering processes, to help criminal money find its way back into the regulated financial system. Banks execute transfers of billions of dollars every year even when they suspect a criminal or corrupt background.[116] According to some estimates, around 100 billion Euros are laundered every year in Germany alone.[117] Money laundering poses a risk to public security, by abetting drug and human trafficking, fraud and other organised crime activities.

The Danske Bank scandal is emblematic of this. Roughly 200 billion Euros were allegedly siphoned through its branch in Estonia, covering up the money's true origins.[118] Meanwhile Deutsche Bank, as well as being involved in the Danske Bank scandal, has created a seemingly never-ending stream of its own money laundering failures: so many, in fact, that in 2018 the German oversight body BaFin sent a special representative to oversee reform,[119] then expanded the representative's mandate in 2021.[120] Banks have been regularly reprimanded by their respective oversight bodies, whether it be HSBC[121], Santander[122] or Commerzbank[123], but they are clearly struggling to implement adequate measures to prevent illicit financial flows running through their systems. Thus, parts of the financial sector promote organized crime and the plundering of countries by corrupt elites.

When we argue that the financial sector needs to shrink overall, the illegal and illicit activities described here are the ones that should completely disappear, as they have no societal value at all. On the contrary, they make our society more unequal, poorer and less safe. Putting in place truly effective systems and structures to fight money laundering would improve prosperity and strengthen democracy – while reducing the size and power of the financial sector.

The concealing of money flows is made possible by numerous detours and additional transactions. It inflates the financial sector. If the illegal and illicit activities described here can be stopped or at least reduced, the financial sector will shrink. Introducing effective anti-money laundering systems and structures could increase prosperity and strengthen democracy - while reducing the size and power of the financial industry.

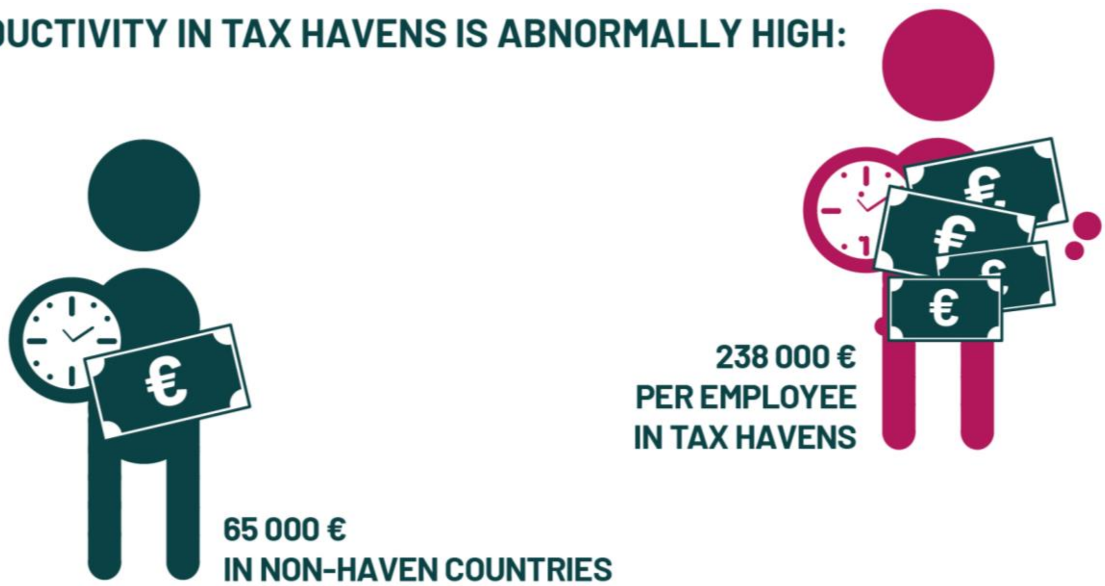
No fair share in taxes

The financial sector invests a lot of energy and resources to minimize its own financing contribution to public services. Financial entities' activities in tax havens occur in both legal and illegal forms. This is well illustrated with complex corporate structures. The 37 largest banks in Europe have on average subsidiaries in 25 different countries, including key tax havens such as the British Virgin Islands, Cayman Islands or Bermuda.[124] These subsidiaries are set up by an army of consultants apparently with the sole intent to bypass financial regulation and reduce tax burdens. The EU tax observatory has found that between 2014 and 2020, 36 large European banks reported 20 billion or 14% of their profits in tax havens each year.[125] The abnormally high productivity of the banks' employees in tax havens – 238 000 Euros profit per employee in tax havens vs. 65 000 Euros per employee in non-tax havens - hint at the fact that the banks shifted profits out of the countries where they provided the actual service.[126] Putting a stop to these illegal and illegitimate activities of banks in tax havens would force financial companies to pay appropriate taxes in the countries where they operate. The transactions necessary to squeeze tax payments, which are completely unproductive for society, would cease. The financial sector would be smaller than it is today.

BETWEEN 2014 AND 2020, 36 EUROPEAN BANKS REPORTED 20 BILLION OR 14% OF THEIR PROFITS IN TAX HAVENS EACH YEAR

Graph 5

PRODUCTIVITY IN TAX HAVENS IS ABNORMALLY HIGH:



Source: Aliprandi, Giulia et. al. (2021): Have European Banks Left Tax Havens? Evidence from Country-By-Country-Date. EU tax observatory.

Box 4: Lehman's corporate structure

An illustrative example of overly complex corporate structures was Lehman Brothers. In the final stage, a total of 209 subsidiaries in 26 countries allowed the group not only to avoid taxes, but also to shield assets from creditors and build up dangerous debt linkages, out of regulators' sights.[127] When the group hit trouble in 2008, it turned out that this structure was extremely fragile, and there were too few assets to pay creditors. The global financial firm collapsed, inflicting massive losses on the economies of many countries.

SHRINK FINANCE TO ENHANCE PROSPERITY

Many people believe that the financial sector is the wealthy goose that lays the golden eggs for society, and that increasing the size of the sector is a route to improving prosperity. Indeed, governments such as France's or Germany's are relying on such an argument as they attempt to capture financial sector activities from London after Brexit.

But does this argument hold water? Does more finance make us more prosperous? This report shows the opposite to be true. We started out asking whether our financial sector in its current form actually serves society.

Our analysis has shown a wide range of activities and practices that are very harmful to society. To start with, the financial sector deals with itself to a large extent, often with negative economic or societal consequences, for example high frequency trading increasing the costs for consumers. In addition, finance is a major source of instability and leads to frequent crises, with additional high costs for society, especially the most vulnerable. Furthermore, many of its practices are aimed at extracting wealth created elsewhere, both from companies and households, on an ongoing basis. On top of this, the financial sector's activities often involve circumventing or breaking the law, to make profits for the wealthiest at the expense of the common good.

Of course, there are useful parts of the financial sector such as credit provision to households and firms that are key to a prosperous society. And of course there are individual players who operate with integrity. But as discussed, these only constitute a fraction of the activities our current financial sector undertakes. Don't take our word for it: this conclusion is shared by a range of studies on the macroeconomic impact of large financial sectors, by the International Monetary Fund, the Bank for International Settlements, and others. The former describes the relationship between financial development[128] and economic growth as follows: while in developing economies, an evolving financial sector is correlated with higher growth, this is not the case for developed countries; beyond a threshold where credit to the private sector is equivalent to around 80 - 100% to GDP, further growth in the financial sector tends to have a negative impact on overall economic growth.[129] The BIS has found a similar relationship between the financial sector and inequality: while the growth of finance is initially assumed to lower inequality, a large financial sector tends to exacerbate it.[130]

The finance lobby is powerful in upholding the myth that regulating finance would constrain prosperity.[131] If the financial sector is to be put back at the service of the real economy, it will have to be more tightly regulated than it is today. In view of the many illegal, unproductive or even harmful financial market transactions, this would inevitably have to be accompanied by a significant reduction in its size. Shrinking the financial sector could also help put an end to misguided incentives, for example through tax-financed bailouts, by ensuring that those who make profits also bear the risk. Last but not least, curbing the illegal and illicit activities of the financial sector could improve public safety.

There are promising proposals to shrink the financial sector and refocus its activities on useful purposes. Similar to the phase-out of fossil fuels, a phase-out of many financial activities is necessary. Unlike fossil fuels, however, we do not want to abolish the financial sector, but need to shrink it to a size that allows it to serve society rather than extract value.

Reregulating finance has not been successful in the aftermath of the Great Financial Crisis of 2007-2008, even though there were a lot of ambitious financial reform proposal on the table, such as:

- A financial transaction tax
- Separating retail and investment banking
- Significantly higher equity requirements for banks
- Regulating shadow banks
- Drying up tax havens
- Banning commissions in financial services[132]
- Banning the sale of derivatives to retail investors
- Stricter requirements for auditing firms

These reforms have the potential to shrink finance and redirect its focus, both in Germany and the European Union. However, they have one thing in common: they have remained proposals. Not one of these initiatives has become law. It is high time to put them back on the agenda.

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