EMPLOYEE SHARE OWNERSHIP AND SOCIAL CAPITALISM

Speech at ESOP Centre Awards Dinner, 30th October 2014

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Thank you for the opportunity to speak this evening at the ESOP Centre awards dinner. Malcolm Hurlston, Chairman of the ESOP Centre, asked me to outline my thoughts on the reforms to the European Union's financial markets - in particular the establishment of the new European Commission - and what this might mean for employee share ownership.

As you may have heard, we now have a new European Commission in place. This has just recently been approved by the European Parliament and officially starts its term of office in a few days time, on 1st November. The actions of the new Commission will have a huge impact on the UK's financial sector, not just the EU financial sector.

The new President of the Commission, Jean-Claude Juncker, pulled a few rabbits out of the hat. He has undertaken a major re-organisation of the structure of the Commission. Of particular relevance for anyone interested in financial markets, President Juncker has carved out of DG Internal Market and Services (DM

Markt) – who we used to pay homage to in Brussels – a powerful new Directorate General with responsibility for Financial Stability, Financial Services, and Capital Markets Union. Of course, some important elements of financial services reform will be undertaken elsewhere – for example, in the Directorate General for Justice (DG Just). But, there is no doubt that the major reforms of financial services will be driven by this new financial services DG.

In a move that raised a few cheers, a few hackles and a few eyebrows, President Juncker appointed Lord Hill as the Commissioner in charge of this powerful brief. Some in the City were practically gloating as they had thought they had got their man in place.

In contrast, some in 'civil society' were concerned and angry given Lord Hill's background – the fear is that, given his background, he would promote the interests of the UK's financial sector over the public interest.

However, at the moment, I am personally fairly sanguine about those risks. I prefer to judge people by their deeds, not their past or reputation.

But, more than that, I'm actually quite optimistic. The creation of this new financial services DG provides a great opportunity to concentrate our efforts on rebuilding and transforming the financial sector.

There are some risks of course. The well-resourced, influential financial services lobby now also has an opportunity to focus its lobbying efforts on this new DG. The financial services industry spends around Euro 120 million annually on lobbying policy and decision makers – 30 times as much as civil society[1].

Nevertheless, as I say, I am optimistic. I urge you to read the letter of appointment President Juncker sent to Lord Hill[2]. This mission letter sets out in no uncertain terms what President Juncker expects from the new Commissioner and the new DG.

He wants to see safer, more resilient financial markets and, critically, financial services that meet the needs of citizens and the real economy. His ambitions and demands seem very much aligned with those of civil society campaigners. I get the sense that President Juncker means business. How the reforms turn out will determine the future of the UK's financial sector.

There is much business to be done. Let's remember what's at stake here. It is not forgotten that the actions of 'Big Finance' nearly wrecked the economies of Europe. The crisis in the financial markets rapidly turned into an economic crisis (in the form of major recessions and stagnation across the EU) which in turn has caused a social crisis. Some economies have not yet recovered and ordinary citizens across the EU are paying a huge price in the form of austerity and reckless conservatism.

But, not only did Big Finance threaten the stability, resilience, and integrity of our financial system, it failed at some of its primary economic and social functions.

What do I mean by that? The primary economic and social functions of the financial sector are:

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[1] http://corporateeurope.org/pressreleases/2014/09/hard-facts-europes-biggest-lobbyists-revealed-first-time
[2] http://ec.europa.eu/about/juncker-commission/docs/hill_en.pdf

- Money transmission and payment facilities – the traditional banking role.
- Providing long term sustainable capital for and allocating resources to the real economy.
- Efficient financial intermediation – that is, transforming savings and deposits into loans for households and businesses in the real economy.
- Efficient risk management – helping households and real economy businesses manage risk for example through insurance or hedging.
- Helping households meet core financial needs such as saving for retirement.

There is, of course, much good in the financial system but it has to be said that Big Finance failed badly on some of those tests. There are numerous examples but in the interests of time, let me give you a few examples to illustrate what I mean with a focus on the UK.

- The average length of time shares are held in the UK stockmarket has fallen from almost 8 years to just 7.5 months (from late 1960s to end 2007)[3].
- The Financial Services User Group (FSUG) - which I chair - undertook a major study called 'Who owns the European Economy? which analysed changes in the ownership of shares between 1970 and 2012[4]. Across the EU, direct ownership by households has fallen from 28% to 11% over the period. In the UK, it fell from 40% to 11% even after the major privatisations in the 1980s/90s.

[3] http://www.publications.parliament.uk/pa/cm201314/cmselect/cmbis/603/603.pdf para 3
[4] http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/papers/1308-report-who-owns-european-economy_en.pdf

- We have seen a huge growth in financial intermediation between ordinary savers and investors and the real economy with all the associated layers of products and fees. This growth in intermediation does not seem to have improved households' financial security or the efficiency of the long term savings and pensions industry. Analysing OECD data, we find that UK managed pension funds produced a real return of -0.7% per annum over the 10 years to end 2012[5]. In other words, the pensions industry couldn't even execute its primary function – to produce decent, inflation beating returns over the medium to long term. Indeed, when we analysed the OECD data we found that UK pension funds underperformed the OECD average in nine out of the 10 years. The failure to deliver decent real returns has a real impact on pension scheme deficits, corporate profitability, and ultimately on the welfare of employees. Moreover, fund managers and stock market analysts are self-appointed arbiters of economic efficiency – that is, their views on company performance can have an impact on share prices, behaviour of company management (who feel pressurised to cut costs), and ultimately wages and jobs. Many feel it is galling that those powerful agents who are supposed to exercise stewardship over assets and wield huge influence over the future of real economy companies and workers are just not doing their own job very well.
- The last example I give relates to concerns that the system of financial intermediation is still not efficiently allocating resources to productive, real economy activities. In the year to end August 2013, 45% of UK bank lending went to other banks in the financial system, 38% went to the property sector, while

[5] Financial Inclusion Centre analysis of OECD data contained in Pensions Markets in Focus, 2013, Table A-9. Indeed, UK pension funds underperformed the average of countries covered in 9 out of the 10 years.

only 3% went to manufacturing[6]. Bank loans outstanding to UK non-financial corporations fell by nearly 30% from Q4 2008 to end 2013[7].

So, with all that in mind, we can see that there are three main challenges facing policymakers at EU and UK level:

1. Restoring and maintaining financial stability and resilience, and managing systemic risk;
2. Making sure major financial institutions are prudently run and resilient against the threat of future financial crises; and
3. Making markets work for the real economy and society.

Much work has been done on the first two challenges. We will not know if these reforms have been successful until the financial system is tested by a new crisis which, rest assured, will come.

The focus now must move to the third challenge. There is a sense that the interests of households and the real economy have become subordinated to the interests of Big Finance. Somehow, we have ended up serving the needs of Big Finance, not the other way around as should be the case.

But what does 'making markets work' for the real economy and society actually mean? And what relevance does this have for employee share ownership?

Making markets work - to my mind – means long term reforms which create and support:

- Financial markets that operate to highest level of standards of corporate governance and integrity;

[6] Adair Turner, presentation at Resolution Foundation event
[7] Financial Stability Board, McKinsey – Economist, p4, Special report on International Banking, May 10th 2014

- End-to-end reform of the financial system – we particularly need to address the role and performance of financial intermediaries who have been extracting and destroying, rather than creating, value for clients;
- A financial system that provides patient, long term capital and sustainable growth in the real economy;
- An economic system that tackles the corrosive economic inequalities in our society;
- An economic system that properly rewards effort and risk taking and shares the proceeds of growth fairly and equitably;

In short, financial market reform not as an end in itself, but as a means to establishing a fairer, more inclusive, more accountable, more interconnected, more collaborative, and more sustainable form of 21st Century social capitalism.

And if employee share ownership doesn't embody that vision, nothing does. As a movement, employee share ownership has a huge contribution to make towards this new social capitalism. The movement deserves to prosper. I wish you all the best for the awards ceremony tonight and best of luck for the future.

Thank you.