"The Regulatory/Supervisory Implications of a Socially Responsible Finance" (February 2018)

Thoughts to honour Udo Reifner

Though I met Udo only four years ago, the fact that our relationship became immediately intense and very fruitful allows me to participate to this special blog without hesitation.

The impression I had since our first interaction was that Udo is very special and that has only been confirmed over time. Though he is clearly one of the most educated and knowledgeable scholar – truly an *eruditum* – I ever met, at the same time Udo is also most determined to use his knowledge and intuition to make a sense of it, so that scholarship can benefit society and particularly the weak and less well represented. Thus, Udo is a 'socially engaged scholar'. That could be easily proven by studying the common tread linking Udo's innumerable contributions. I will not do that since it would take me away from my limited assignment of focusing on Udo's role in terms of "The Regulatory/Supervisory Implications of a Socially Responsible Finance". However, I felt that it had to be said at the forefront.

Specifically, given my inability to read his works written in German and also because of the limited topic I selected, my comments refer to the following three publications in English language:

1. (2002) (ed) Micro-Lending – A Case for Regulation in Europe, Social Finance vol.5, Nomos: Baden-Baden (Reifner, U., General Report pp 17-79; Micro-Credit by Non-Banks under Italian Bank Law pp 289-308).
2. (2001) Reifner, Udo/Evers, Jan, The 3rd Banking Directive: A CRA for Europe, in: INAISE (Ed) The Social Responsibility of Banks, Brussels 2000; frz.: "Banques et Cohésion sociale – pour un financement de l'économie à l'échelle humaine", INAISE: Brüssel.
3. (1998) Control of Banks in a Deregulated Market – Towards Community Responsibility in Europe, in: Rudanko, M./Timonen, P. (Eds) European Financial Area, University of Helsinki, Saarijärvi S.61 – 92.

The second and third works are more related to each other. Although not totally unrelated to the other two, the first report can be discussed separately. I will start with this.

In line with the 'socially engaged scholar' role, the paper starts clearly defining the various forms of Micro-Lending and of the subjects involved but also spells out the social implications. Specifically, it identifies four main aspects the regulators should be aware of:

> i) a financial aspect, providing banking services on a small scale to people who might otherwise be financially excluded;
>
> ii) a labour market aspect, where creating self-employment through credit provision aims to reduce unemployment and poverty;
>
> iii) a community development aspect, where channelling capital into under-served and deprived communities or countries boosts the local economy;
>
> iv) a social welfare aspect, where in a subsidiary manner Micro-Lending can reduce the need of welfare subsidies.

The above aspects are then analysed along the three institutional approaches identified throughout the EU: 1) the market approach typical of the UK; 2) the welfare state approach distinctive of Germany and the Netherlands; 3) the social lending approach typical of France.

This twist exemplifies how Udo is particularly attentive at casting theoretical discussions within the specific institutional setups.

The report advocates that micro-lenders should have the status of having a legal personality, rather than being treated as individuals and that micro-lending be assessed without regard to specialist legal structures for micro-lending institutions such as associations or co-operatives and that any institution able and willing to meet the criteria of micro-lending should be permitted to engage in it. Also, it is argued that social micro-lending should be subject to adequate protective private law such as the Consumer Credit Directive and usury legislation.

The report lists a complex series of considerations and then comes to the recommendations:

> a) social micro-lending via non-banks should be permissible by law and the additional costs in terms of risks, education, urban development and advice be subsidised so that a reasonable return on the loans can be realised;
>
> b) social micro-lending should be shaped as a scheme of instalment credit up to €10,000 to individuals at risk of financial exclusion aiming to educate them in financial literacy and create micro-enterprises to combat unemployment/favour community development;
>
> c) as an ancillary activity to non-financial social policy measures, micro-lending should be treated just as other non-bank credit (i.e. leasing, factoring);
>
> d) Member States (MS) should apply the standards of the Consumer Credit Directive to micro-lending and take preventive measures against usury and predatory lending;
>
> e) micro-lenders should be given easy access to refinancing;
>
> f) MS should facilitate group guarantee schemes;
>
> g) MS should create public awareness on access to financial services for business start-ups and provide incentives for banks to advance micro-lending schemes.

Udo's 'socially engaged scholar' approach emerges in the many dimensions of the report, along with his unique ability to melt that social drive with in-depth knowledge of the legal, institutional aspects but also together with an acute talent in economic reasoning, something no longer common since law and economics strode away from each other.

The second and third works impinge on how to ensure that banks in Europe act responsibly to their communities and stakeholders. Without going into detailed description of the two papers I will just underline a common element. In both works we can find an in-depth analysis and discussion of the theoretical underpinnings as well as of the real institutional set ups followed by pragmatic proposals to ensure that banks are kept responsible to their communities and stakeholders. An aspect worth stressing is the clear and repeated reference to the Community Reinvestment Act (CRA), which, even though perfectible, has worked in the US. I found his repeated reference to the CRA regulation paradigmatic of Udo's approach. In other words, Udo is a superb example of a scholar who not only engages in interdisciplinary fields but refrains from being hostage of purely formal theoretical discussions. Even though his background is deeply entrenched in the continental European critical and historical thought, Udo manages to escape the trap of theories that would be inner consistent but not applicable or little relevant in practice. Instead, he always keeps searching for pragmatic solutions that might at times seem theoretically imperfect but will work on the ground.

Udo's approach is therefore particularly important for today's Europe. In fact, the process of European integration over the latest thirty years or so has fallen prey to what Joe Stiglitz calls 'market fundamentalism'. In other terms, a single monolithic reference and trust in free markets has shaped European integration. In my view, but I don't think I'm alone to think it, this raises not only an issue of appropriateness but also of legitimacy.

The legitimacy of a democratic state, as well as of a democratic project of super-national Union (such as the European Union), postulates, in fact, that it respects the founding values of their peoples. Differently from the US (and, in part, the UK), where the majority of citizens believe that each individual gets what he/she deserves, European peoples – irrespectively of their religious faith and/or of latitude and longitude – believe that in general it isn't true that each individual gets what he/she deserves. Rather, Europeans view an individual's income and wealth to depend on factors largely outside his/her control: the percentage of Eurozone citizens agreeing with this view is a majority above 60%, as against minorities of 44% in the UK and 41% in the US (source: Pew Research Center (2014) Inequality Report, retrieved on 8/Jan/2016 – due to data availability, the Eurozone is approximated by the population weighted average of France and Germany).

This leads to different inclinations to the free market, which delivers outcomes in line with each individual's effort in the US' view but not in Europe's view, and, so, different judgments on the need/opportunity to regulate markets in ways to avoid potential distortion building disadvantage for the weak as well as to intervene with mechanisms of solidarity to support them. This argument nests on a fact: even after the fall of Communist regimes, contrary to what theorized in the early 1990s by Fukuyama, Capitalism does not have a single shape but multiple ones (e.g., Hall & Soskice (2001)).

So, if different varieties of capitalism exist, why do we have these differences? And do these differences result from historic and institutional sedimentation, which may be easily modified? Or, instead, do they correspond to peoples' founding values? Replies to these questions are not obvious. On one hand, one might hold – a liberal thinker would certainly concur with this – that Europeans have little trust in the free market because they rarely tasted it, i.e. the very fact that markets are less free in Europe ends up generating Europeans scepticism in markets (like a dog biting its own tail). Also, along this view, values in support or against markets would be determined endogenously. On the other hand, however – this is my view, certainly following Stiglitz and I believe Keynes – one can hold that values are in great part exogenous as they reflect culture, ethics and moral sediments, traditions of organizing society etc. Thus, if we believe in this second view, one needs to adapt markets and institutions to values. We cannot go the opposite way.

Then, if values are predetermined and European values are sceptical on the free market, we can easily identify as a grave error having entrusted the European unification exclusively to the logic of the free market. That undermines the democratic legitimacy of this project, which was conceived in the name of the European peoples. We need to rapidly become aware of that, not in the interest of this or that member country. Rather, we have to put back on track something that has been derailing not because of minor errors of leadership but because of the utmost fundamental flaw of having disregarded the hearts of the Europeans. From this perspective, recovering the social dimension of the EU and deploying effective solidarity mechanisms acting transversally through the Union, more than fixing actions, are essential ingredients towards the return of the lost legitimacy. Naturally this holds assuming that, differently from Paradise Lost by John Milton, Europeans wish to be in Eden.

Now I wish to draw the implications of my argument – about the lack of legitimacy of the free-market-based process of EU integration – in terms of the regulatory/supervisory implications of a socially responsible finance. The EU banking regulation approach has been one-size-fits-all (each bank has to follow the same rules, irrespective of its ownership structure and mission), contrary to the US tiered approach, where commercial banks follow a set of rules different from community banks and yet other rules apply to credit unions. The result of the one-size-fits-all EU approach is that all banks are pushed to behave in the same manner, as if they were all profit maximisers. In turn, this violates the principles of proportionality and subsidiarity and provokes the dilution of social responsibility even for those bank types whose DNA is oriented to serve their stakeholders – rather than pursue profit maximisation – such as the cooperative banks and the savings banks.

In that, EU regulators/policy makers' one-size-fits-all approach disregards (if not despises) the specificities of stakeholder-oriented banks. We even have the paradox that Credit Unions and Community Banks – local parallel of the EU stakeholder banks – receive a differential treatment in the US, where peoples' majority values are not so keen to the solidarity mechanisms activated by stakeholder banks.

This is the exact opposite of Udo's flexible paradigm, which advocates introducing the CRA approach also in Europe. While the one-size-fits-all approach is clearly a problem for ensuring that European banks keep responsible to their communities and stakeholders, this seems to be largely the result of an erroneous view based on a sort of idolatry of the free market, oblivious of market imperfections and of the social consequences of that mistaken approach. Correcting these mistakes hinges to a large extent on having scholars like Udo that keep thinking independently and remaining vocal. Long life to Udo!

Giovanni Ferri