Debating responsible innovation in finance: viewpoints and commentaries

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Debating Innovation 2012 Vol. 2(1): 1-11

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Abstract

Several pressing issues were raised at the Conference on "Debating Responsible Innovation in Finance" held at Mines ParisTech on November 30th, 2011, ranging from the potential perils of new, complex financial products to the consequences of high-frequency trading, from the role of incentives in the financial services industry to the democratic assessment of financial problems and solutions. This article gathers various analyses and commentaries on that day's intense debate from contributors to the Observatory for Responsible Innovation. Alexandre Pointier, a former practitioner of financial innovation, teaches at Sciences Po in Paris. Stéphane Delacôte, administrator at Mines ParisTech's foundation, is also a former practitioner. Yamina Tadjeddine is an economist at Université Paris Ouest Nanterre. Marc Lenglet, a former compliance officer, is a professor at the European Business School in Paris. Fabian Muniesa is a researcher at the Center for the Sociology of Innovation at Mines ParisTech. Annalivia Lacoste is the Observatory's project manager and the chief editor of *Debating Innovation*.

Annalivia Lacoste:

About a hundred attendees were counted at the Conference on "Debating Responsible Innovation in Finance": mostly practitioners from the financial services industry, but also regulators, journalists, actors from the political sector, academics and students. Here is a short summary of the topics that were tackled. The initial roundtable discussion was devoted to the problem of dangerous externalities and to how to cope with the negative unforeseen consequences of financial innovation. Shyamala Gopinath, former Deputy Governor of the National Reserve of India, discussed the Indian regulatory experience and Sarai Criado, from the European Commission, directed attention towards critical cases such as ETFs (exchange-traded funds), hybrid complex MTNs (medium-term notes), sovereign CDS (credit default swaps) and liquidity swaps. A lively discussion with the audience followed.

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The second roundtable discussion tackled the specific case of high-frequency trading (HFT) and automated trading at large. The discussion counted on the viewpoints of Yann Muzika, former practitioner in this area now at Magnet Investment Advisors, Charles-Albert Lehalle, a specialist of high-frequency trading at Crédit Agricole Chevreux, Oliver Burkart from ESMA (European Securities and Markets Authority), Jean-Pierre Zigrand, economist at the London

School of Economics, and Yuval Millo, a sociologist of finance, also from the London School of Economics. Michael Power, Director of the Centre for the Analysis of Risk and Regulation at the London School of Economics, provided a series of commentaries on the morning sessions, with a focus on what financial innovation could learn from the governance and assessment of innovation in other areas, from technology to medicine.

The third roundtable discussion, titled ”responsible actors”, shifted attention to the pressing issue of incentives: not only bonuses but incentives at large, and their capacity to foster responsibility and irresponsibility in financial, economic, regulatory and political behavior. Contributors to the debate were Pascal Canfin, Member of the European Parliament, Jean Pierre Mustier, Head of UniCredit Corporate and Investment Banking Division, Loïc Fery from Chenavari Investment Managers, Olivier Godechot, sociologist at the CNRS and Paris School of Economics, and Nicolas Véron, Senior Fellow at Bruegel and a member of the Peterson Institute.

The fourth roundtable discussion introduced the topic of ”democratic innovations”: the idea was to discuss measures that could strengthen a more participatory approach to financial innovation and oversight, with a deeper understanding of public scrutiny and collective responsibility in the face of risk and uncertainty. The discussion focused on the viewpoints of Michel Péretié, CEO of Société Générale Corporate and Investment Banking, and Valérie Rabault, Head of Market Prospective and Business Risk at BNP Paribas, with the participation of Stéphane Delacôte, Alexandre Pointier and Marc Lenglet, members of the Observatory for Responsible Innovation, in their capacity of former practitioners from the financial services industry. Bruce Kogut, Director of the Sanford C. Bernstein & Co. Center for Leadership and Ethics at Columbia Business School, offered a view on the afternoon discussion, with a focus on the present situation in the United States.

Alexandre Pointier:

I was pleased to contribute to the organization of the roundtable discussion on ”responsible actors” for the conference on ”Debating Responsible Innovation in Finance”. Gathering around the same table the director of a large investment bank (Jean Pierre Mustier), a sociologist specialized in bonuses in the financial industry (Olivier Godechot), a European MP (Pascal Canfin), a researcher at the Bruegel Institute (Nicolas Véron) and a hedge fund manager (Loïc Fery) was a unique and priceless experience. The Observatory for Responsible Innovation was created because we started to realize the huge gap existing between the financial world on one side, and governments and civil society on the other side - a gap that is both an information gap and a cultural gap. This kind of debate is undoubtedly the first necessary step to reconcile these two worlds. However, the purpose of such a conference cannot be but humble. The viewpoints of the various stakeholders are expressed and debated, but you

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rarely obtain a consensus at the end of the day. One discovers the value of this kind of exchanges analyzing them after the fact.

I think the conference shed light on two major issues that can explain the actual stillness in terms of regulation. The first is the fact that the economic crisis prevents us from thinking about anything else but the crisis (and its origins).

The economic crisis is absorbing us, and it would be nonsense to raise a new issue that would not be at the top of the economic agenda (national debt, growth and austerity measures, rethinking the European project, etc.). Jean Pierre Mustier precisely reminded us of this during the conference, after Pascal Canfin introduced the recent debates on bonuses at the European Parliament: how can we discuss bonuses and innovation - Mustier warned - whereas the crisis is getting worse day by day and that we could all end up living in a cave tomorrow? This apocalyptic prophecy distracted an audience yet very concerned about the idea of defending a new culture of responsibility in the financial industry. The short-term pressure is real, and governments and regulators have very limited recourse. Yet we should use this window of opportunity to solve other problems, not directly related to the current crisis. The necessity of becoming counter-cyclical is at the core of the regulation measures today and urges us to act differently. Innovation is not a top priority for investment banks anymore. We could even ban financial innovation today without any damage for the banks, and they would probably not oppose that - although they would have hardly fought against any reform of the innovation process prior to 2008. If you would give the choice today to European banks between hardening the monitoring of new products, or the increase in equity for Italian convertibles, they would definitely favor the second option. Let us take this opportunity to think about new ways of supervising financial products from now on.

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The second fundamental problem that the conference highlighted is that states are held hostages by the banks.

The reason the audience was so receptive to Mr Mustier's speech during the conference is that everyone acknowledges that banks are the lungs of the economy, and that, without them, all the economic system can instantaneously collapse. No need to have an expert knowledge to understand that banks will use their most powerful instrument (the leverage on the economy) when they feel the wind is turning. Whatever measure is discussed (increasing the capital requirements, reinforcing the regulation on innovation or squeezing CDS), the rational banker will use the worst-case scenario (that is, the loans amount) as an argument to negotiate, in order to put off potential reforms. But as regards the current economic system, Mr Mustier is right: if the state's constraint on capital requirements is too strict, the banks will grant fewer loans, with bad consequences on SMEs and customers.

Mr Mustier is right indeed, and maybe we should consider not imposing short-term constraints to banks. However, we must now think about the ways to restore stability in the balance of power between the states and the banks. Would the solution come from a new public bank to create a distributive channel between the state and the real economy? Do we have to advocate for a tighter regulation of state subsidies to private banks? Should we clarify the issue of state guarantees *ex ante* with a contract with private banks? There is an urgent need to discuss these issues.

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The Latin poet Publius Syrus once wrote that "reflection time is a saving of time". He insisted on the tension that prevails between the necessity of short-term solutions and the need to project ourselves in the future. In the area of financial regulation, this balance needs to be restored.

Stéphane Delacôte:

My first impressions once the debates of November 30th, 2011, ended were that they had been much softer than what I had expected. Everybody in the panels had been polite and the questions raised by the audience were rather soft. This came in contrast with the debates we already had at the Observatory but also with what can be read every day in different newspapers putting the blame on the banking community for all sorts of sins. We wished to create a forum where debates could be launched and controversial issues could be put on the table, but also where we could also find answers. Difficult questions did not come in numbers in the end.

The only explanation I found of this phenomenon was that the assembly was mostly composed of bankers or former bankers. We were so stressed about the success of this conference that we invited a very wide number of people (well in excess of available seats!). Bankers but also academics, regulators, journalists and students had been invited. The room was full but the composition of the audience proved that the strongest expectation to discuss the issue of responsibility in finance actually came from... bankers themselves! They represented around two thirds of the attendees. This phenomenon has also been verified within the panels. We feared that some important bankers, the major risk-takers in our debating exercise, would not come or would cancel at the last minute. They eventually came and played the game whereas most of the invited politicians cancelled, at the notable exceptions of Pascal Canfin and Joël Labbé, two members of French Green Party "Europe Écologie-Les Verts".

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We had really interesting discussions, even if not the most controversial ones. The debate around the size of the banking industry and its role in respect of complex innovations was the one I considered the most important. Should banks shrink and come back to the traditional role they played before we invented derivatives or should they continue to be able to take complex risks? Should complex risks move to the "shadow banking" sector or should we keep them inside banks? Ideas for smart regulation emerged as potential solutions from these collective debates and could bring a lot to this discussion. The Observatory has already been working with this perspective in mind since its creation. I do believe our work could really contribute to the advancement of this issue, in particular through our analysis of the potential role of New Product Committees, analyzed in a paper forthcoming in the *Journal of Financial Regulation and Compliance* (volume 20, issue 2).

By way of conclusion, I would say this conference proved a real wish from the banking community (without the help of which smart and pragmatic regulations could not be monitored) to be challenged and to participate to collective debates to reinvent new rules for the entire system. Our society still needs to find the right answer to build on their constructive message.

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Yamina Tadjeddine:

I had taken part in the activities of the working group on responsible innovation in finance since its launch in 2010 but was not really involved in the organization of the conference because of my maternity leave. When I came back to the group in September 2011, I was pleased to discover the project had taken shape and I was impressed by the high standard of the invited contributors. I decided to participate because I was convinced this conference would be a rare occasion to learn from the four roundtables gathering mostly practitioners, regulators and academics. My expectations were met, but not necessarily in the way I had expected, and this experience was very stimulating.

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I want to start with what struck me the most during this day: the ready-made institutional speeches, whether they came from practitioners or politicians, and the difficulty of an open and free debate. Whereas our working group meetings were a discussion forum where anyone could express his viewpoints and his understanding of current events, the majority of the speeches (with the notable exception of the first roundtable with Shyamala Gopinath and Sarai Criado Nuevo, and Jean Pierre Mustier's speech) did not touch upon any ethical issue - practitioners, politicians and regulators' monologues where the lack of dialogue symbolizes the impossible agreement of these antagonistic worlds.

The "bad-boy trader" with his bonuses was answering the questions of obsequious and misinformed regulators. The virtuous hedge fund manager and the high-frequency trader swore that they create liquidity and efficiency, whereas the politicians were concerned by the common good and the decrease of markets instability induced by the general tendency. Well-structured presentations, unprepared speeches and speech written by loyal and abiding employees of an investment bank surrounded with the communication staff all sitting in the front row, made no difference to the deathly boredom of this succession of ready-made monologues.

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These verbal jousting between two visions of the financial world was sterile and vain. I had already perceived these issues during my research when we discussed the UCITS III directive in Brussels and during investigations for a report commissioned by the AMF (The French Financial Markets Authority) about hedge funds. We had several discussions with some of my friends working in the financial industry in Paris or London who would usually put me down as a post-marxist academic whereas Michel Aglietta, advocate of the regulation of the financial markets, would think I am a hayekian. I had been warned in the past but yet I was even surprised with what I heard. I naively thought that lively debate would have emerged at that occasion, during this day which was touted as a forum for discussion with people who had freed themselves from their institutional shells. It was not the case in the end but it makes sense since the Maurice Allais Hall where the conference was held at the École des Mines de Paris was not the small room where we had our previous protracted but fruitful debates.

Nevertheless, this state of affairs reveals the reality of a financial sector which is heavily regulated but where the issue of responsibility is never truly tackled. Yet, I think that discussing responsibility imposes an ethical framework as well as a personal commitment which goes beyond the usual questions, whenever they come from the regulation sphere or the financial practice. Responsibility cannot be summarized by technical approaches where one measure would be sufficient to decide what threatens the common good or not. The debate is the tool that helps us to overcome a positioning of experts in order to introduce human, social and political elements. But neither the regulator nor the banker wants to get out of his own arena. Both have very antagonistic views of the financial sector and the compromise turns out to be impossible. The finance lobby can impose a way of looking at things, but the regulator will try to resist - an endless battle where the political dimension slightly disappears.

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For me, the Observatory for Responsible Innovation is a forum where we try to go beyond these shifts and to promote a new vision of finance as a democratic forum where all type of opinions can be expressed and heard. A democratic playing-field, as Bentham described it, where moral values and utopias are playing an important role, where the financial sector is not summed-up to the experts' fighting. Without a proper debate, without the expression of personal opinions, democracy cannot exist. Only three speakers played this role on November 30th, when they expressed what they thought was good or bad: Shyamala Gopinath, Sarai Criado and Jean Pierre Mustier, two regulators and one practitioner. I will not judge their opinions, they are all justifiable. I would like to conclude this comment by thanking them because they made the demonstration that it was possible and necessary to reintroduce a political and a moral dimension in the debate about financial issues. This debate is just beginning but is crucial if we want our society to progress.

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Marc Lenglet:

The November 30th, 2011, conference on "Debating Responsible Innovation in Finance" was remarkable in more than one way. In particular, it achieved in my view demonstrating the problems of discourses that attempt at articulating finance and society. The discussions showed one particular lack: the lack of words. Some analysts have emphasized the role played by language in the financial crisis (I think of Gillian Tett or Donald MacKenzie), and the conference pointed to that again. I want to focus on two examples: the discussion on high-frequency trading, and the debate on democracy in financial innovation. I was hoping to witness the limits of a certain kind of financial language in accounting for the "thickness" of the vocabulary of responsibility. And I did. I did indeed witness some kind of semantic silences.

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The roundtable discussion on high-frequency trading was about expert speech. The paradoxes and issues raised by the practices of automated trading are overwhelming. It is just difficult to make sense of them with precision, and the deep engagement with technicalities is almost a requirement. The consequence is that debates on high-frequency trading are often inaccessible. The audience remained passive. The roundtable discussion on participatory democracy and financial innovation raised a comparable issue. The debate was somewhat frustrated - and self-contained. In a sense, speech suffered from lack of explicitness. Technical references to responsibility in the financial organization (procedures, measures) sided with too abstract references to the experience of responsibility in general, which translated into a friendly confrontation of realities that were semantically at odds.

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Both cases are about language (financial language) and its problems. I felt the profound incapacity of technical language to cope with the problem of the intentionality which is at the core of the responsible act. But there is a way out, or at least a couple of indications in that direction. We can indeed work on the vocabulary of responsibility in financial innovation as a way to semantically appropriate it.

As Yamina Tadjeddine suggests in her commentary, responsibility goes with a personal claim and personal commitment. The idea of responsibility should not be reduced to a technicality or to a mere procedure. Technical aspects are important, but not sufficient. Once a normative frame has been put in place inside the organization, then starts the work of interpreting and appropriating it in practice. The idea of responsibility circulates within the organization, become part of a shared vocabulary. And it faces the danger of becoming a too simple, a too easy idea. But the idea of responsibility is rough, sometimes bitter and cumbersome (as Levinas rightly suggests), definitely demanding - and should remain so. It is the highly demanding character of the idea of responsibility that should be put at the core of responsible innovation in finance. But this is difficult, since financial objects often lack the material grip that reminds us that demanding character. Financial objects are sometimes fuzzy and elusive (what is a CDS *in concreto* and where is it?).

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We observe, since 2007, the culmination of a crisis of financial language. This crisis is a failure of notions that can hardly made explicit (take the example of high-frequency trading) and also a failure of speech, that is of the processes through which language is shared (take the example of the difficulties of democratic assessment of financial innovation). I interpret this failure as a loss of the "leafy" character of language (Roland Barthes would talk about the *"feuilleté du langage"*).

To engage with the thickness of financial language is one possible way to modify the manner in which professionals from the financial services industry understand their responsibility. This is not about stigmatizing financiers, but rather about creating bonds between finance and citizenship. It is also about developing a democratic consciousness, a democratic curiosity towards the complexity of financial innovation - at least among elected representatives.

Participating in financial innovation, as a bank employee, a financial analyst, a fund manager, a client or a citizen, requires coping with responsibility - that is, facing a perspective of response, which means accepting debate and engagement. I think that we will achieve productive debate once we will reach the "deep level" of the language of responsibility. This means going beyond a discourse on responsibility "about" this and that, and engaging with a discourse of responsibility "within" this and that. In a world of exacerbated antagonisms ("them" vs. "us"), this semantic craft of responsibility can be the clue.

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Fabian Muniesa:

A number of interesting insights can be drawn from the discussions that were held in Paris on November 30th, 2011, during the conference "Debating Responsible Innovation in Finance". I would like to emphasize four of them, out of a personal impression.

One first, most salient outcome is the radical need for actors involved in financial innovation to learn from the governance and assessment of innovation in other areas. We observe the development and diffusion of many varieties of financial innovation, but we hardly find their corresponding laboratories, their necessary testing procedures, and their precautionary assessment and certification methods. One has only to think of what technological innovation or biomedical innovation implies in terms of experimentation, safety trials and market authorization to realize how poor the corresponding practices and institutions are in finance. There are notable exceptions, and some regulators are considering for example calibrating the introduction of specific financial innovations in order to assess their behavior before larger-scale diffusion (see the Indian model, for example). But the idea that markets are real-scale testing sites for financial innovation and that they should consequently been considered and configured as such (think for example about clinical trials, marketing authorization and pharmacovigilance protocols in the biomedical industry) is not yet prevalent in the financial services industry. Critical cases such as ETFs (exchange-traded funds), hybrid complex MTNs (medium-term notes), sovereign CDS (credit default swaps), liquidity swaps or CoCos (contingent convertible bonds) are good candidates for such an approach today.

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A second point that needs to be highlighted is the importance of the uncertainty of externalities. The case of automated trading (high-frequency trading in particular), a quite controversial practice, can give good evidence of that. It is true that a discussion on this topic could focus only on the moral ground (or lack of it) of these type of activity. Are traders who develop these trading strategies purely opportunistic actors? Do they favor a game which lacks any sense of social purpose or economic function? But what if they do so? Is not that, at least in part, the "name of the game"? Such kind of discussion is of course relevant. But it runs the risk of neglecting a concern that all actors (opportunistic or not) can share, which is the problem of negative externalities, that is, of the potentially disruptive, unanticipated consequences of high-frequency trading. A heated debate based on clear-cut positions and straightforward rationales fades out in favor of a discussion on the problem of unintended effects - a discussion in which hesitation is shared by all. One open issue, for example, is the prospect of feedback loops and systemic chain reactions that may be triggered by odd interactions between trading algorithms, and the magnitude of the price variations these could cause. Another is the potential disappearance of current market-making and liquidity-enabling professionals and the radical transformation of the social structure of the financial services industry. To this adds the uncertainty regulators face with regard to the regulatory

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repertoire that can properly identify situations of purposeful manipulation or fraud in the event of trading decisions performed by trading automata. Aside from considerations on what financial reality ought to be, considering it just as it is opens up the collective concern of negative externalities which affect the industry collectively.

A third relevant issue is that of the identification of wide, fundamental responsibilities in the present situation. The current financial crisis and the prospect of a debacle of ample portions in Europe foster a sentiment of urgency and disarray. We reach a point in which the discussion on responsible innovation in finance needs to meet a wider discussion on social order and disorder. The problem of the allocation of credit within the banking system and the problem of the distribution of income in society are critically intertwined. One point of contention is economic compensation in the financial services industry. The regulation of bonuses and salaries of high-profile managers and employees in the industry is praised by some as a potent device for the taming of financial hubris and the development of a culture of restraint and responsibility. Others argue that this is a misguided fix that overlooks the more fundamental prospect of the collapse of credit and neglects the consequences that this may have in terms of severe social disorder. But the current social order is one in which the small group of individuals that appropriates the higher levels of wealth is composed, to a very great extent, of participants from the financial services industry - and this is also an element of social disorder.

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A final element that deserves to be pointed out is the relevance of a detailed look at how financial innovation is handled inside investment banks and financial institutions. Internal procedures and governance methods are idiosyncratic and depend on the bank's organizational culture. And they surely cannot replace regulatory oversight and legal enforcement. But they constitute the nucleus of financial innovation as a practice and industry-wide initiatives aiming at increasing accountability within the internal committees in which financial innovation is discussed at an early stage may prove both beneficial and practicable. The conference on "Debating Responsible Innovation in Finance" attracted a number of practitioners from the financial services industry that have expressed interest and agreement on the need to retool New Product Committees, increasing their role, their accountability, their deliberative capacities and their openness to external appraisal.

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Any more comments? The conversation is open.