The finance industry is destroying the US economy

Michael Edesess | EDHEC-Risk Institute | 21 October 2015

According to a study by Harvard Business School professors Robin Greenwood and David Scharfstein, the percentage of US GDP attributable to the financial industry tripled from 1950 to the 2000s. The percentage attributable to asset management alone increased by more than a factor of ten just since 1980. Has any of this increase improved the services rendered by the financial services industry to the real economy?

All of these questions are answered in economist John Kay's splendid new book, Other People's Money: The Real Business of Finance. I will not be able to do this book sufficient justice in a review, so I recommend that all participants in the financial industry, as well as in the real economy, should read it in its entirety.

1. WHAT HAS THE MODERN FINANCIAL INDUSTRY DONE FOR THE REAL ECONOMY?

The purpose of financial intermediation, Kay explains, is to channel capital – which derives from personal savings – to two uses. The first channel takes bank deposits and converts them to loans, chiefly for mortgages. The second channel takes another part of personal savings and channels it to investments. The purpose is to enable savers to grow their savings, and to provide homeowners, governments and businesses with needed capital. Between the source and the applications of the funds, in both channels, are financial intermediaries.

According to Kay, until a few short decades ago, these financial intermediaries were staffed with second-tier college graduates with leisurely, boring jobs who were better at relationships – such as on the golf course – than at technical challenges. They earned adequate but not spectacular incomes. Since then, the financial intermediaries have increasingly hired the top-tier college and university graduates. Their average incomes, especially those in the upper levels of the industry, have pulled light-years ahead of other people's incomes, taking – by dint of association – the incomes of top-tier executives in non-financial industries with them.

Has this change improved the routing of personal savings to capital needs in the two channels? Not discernibly. And it seems to have increased risks, even to whole economies. In addition, it imposes a tax on the entire non-financial sector.

2. HOW HAS THIS HAPPENED?

As I'll discuss in detail later, this has happened through a combination of concepts emanating from academic institutions, financial enticements to industry insiders and their supplicants and regulators, and information asymmetries. Financial industry intermediaries have managed to obtain financial support for their self-dealing by imposing taxes on users of finance and obtaining catastrophe insurance from governments - either free or at below-market cost.

The extent to which not only users of the financial system, but also the language of regulatory structure itself, have been captured by the financial intermediaries can be measured by the disproportionate importance conferred on the pursuit of liquidity. Says Kay, "Nothing illustrates the self-referential nature of the dialogue in modern financial markets more clearly than this constant repetition of the mantra of liquidity."

What's so important about liquidity? Kay again: "[E]nd-users - households, non-financial businesses, governments - have very modest requirements for liquidity from securities markets... these needs could be met in almost every case if markets opened once a week - perhaps once a year - for small volumes of trade... The pursuit of liquidity often seems to mean little more than the facilitation of trading activity as an end in itself - trading is to be welcomed because it promotes trading."

The industry of ever more highly paid financial intermediaries trading only with themselves has captured regulators - and even the financially literate media - by winning widespread acceptance of its mantras of liquidity, price discovery and transparency. Liquidity and price discovery promote only trading for traders; transparency promotes, or at least does not mitigate, information asymmetry by requiring the delivery of an unassimilable amount of confusing information.

Part of what went wrong was that many financial companies - such as Goldman Sachs - that used to be partnerships converted to limited liability companies. Instead of having their own wealth on the line, managers were instead playing with other people's money and had only limited liability themselves. The result was something that Adam Smith had warned about in his famous book, An Inquiry into the Nature and Causes of the Wealth of Nations:

> "The directors of such companies..., being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

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Another influence was the elevation of "shareholder value" to become the focused goal of running corporations. Kay quotes from a journalist who interviewed John Reed and Sandy Weill, who were briefly co-CEOs of Citigroup in New York:

> "The model I have is of a global consumer company that really helps the middle class with something they haven't been served well by historically. That's my vision. That's my dream," said Reed. "My goal is increasing shareholder value", Sandy (Weill) interjected, glancing frequently at a nearby computer monitor displaying Citigroup's changing stock price."

In spite of Weill's different goal, Kay points out that after Weill ousted Reed, "within eight years, Citigroup's share price would have lost almost all its value and the business would be rescued by the US government."

So much for the single-minded pursuit of shareholder value.

3. WHY THE FINANCIAL INDUSTRY MAKES SO MUCH MONEY

3.1 The role of information asymmetry

Perfect market theory begins with the postulate that all market participants have the same information. Regulatory provisions try to ensure that this assumption holds true, mainly by promoting "transparency." If all actors have the same information, then the only differences in their valuation of assets must be because they have differing preferences and different timing of their needs for money.

But transparency doesn't assure equal information. It may assure equal "access" to information but not equal information, if that information comes in huge doses that are difficult to assimilate. In fact, dumps of unmanaged information in the name of transparency – for example, the long list of "risks" that accompanies prospectuses (I have even seen "the risk that not all risks have been included in this list" listed among the risks) – which are delivered because of lack of trust in managed information, can help to assure information asymmetry. As Kay says, "The answer to information asymmetry is not always the provision of more information, especially when most of this 'information' is simply noise, or boilerplate."

Kay says that "[m]arkets for securities are, in large part, based on differences in information, or perceptions of information, between the two parties to the transaction, rather than on differences in preferences and capabilities. This observation helps to explain both why finance can be, or can appear to be, inordinately profitable, and why that profitability need bear no relation to the value added from financial activities."

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The outsized profitability of financial intermediation is due to the fact that users of it don't have knowledge of the true value of that intermediation. Consequently, financial intermediaries can charge their users whatever they think they can make the users imagine it is worth. These charges include direct fees and arbitrage profits made - as for example with CDOs (collateralized debt obligations) - when a financial intermediary convinces customers that the parts of a tranched or segmented product are worth more than the cost to the intermediary of the whole.

Much of the innovation in the financial intermediation world is, in fact, devoted to making the users believe that the intermediation is worth a fantastic amount. This applies particularly to most of the "research" in the field which is designed, with the collaboration of the academic finance profession, to look as sophisticated and arcane as possible. But as Kay says, "Most of what is called 'research' in the financial sector would not be recognised as research by anyone who has completed an undergraduate thesis, far less a PhD."

A large part of the innovative activity at financial firms, as I can attest from my own experience, is also devoted to making the large fees that customers are paying as unnoticeable to those customers as possible. Given all of this, Kay reasonably concludes, "The best and certainly least risky way to better returns is to pay less in fees and charges to the finance sector."

3.2. The role of governments

In addition to the tax imposed on customers by financial intermediaries because the customers don't know what their service is worth and aren't fully aware of what they're paying, the financial industry also benefits from low-cost or no-cost government-provided catastrophe insurance. This makes the industry less attentive to its own risks and to those it is imposing on others.

Kay makes a wonderful analogy to the supply chain for milk - but it could be the supply chain for food, water or electricity, as well as money. His childhood experience was that milk deliveries were provided when needed, even when there was an upsurge in demand. This was because the milk-delivery supply chain had slack and stockpiling built into it to cover demand variations. But now suppose that "the government were able and willing to intervene to provide milk when there was a possibility of shortage." Then, "milk suppliers would have less reason to maintain stocks of milk. Intervention would therefore frequently be required, and it would appear that the supply of milk was unreliable. The necessity of intervention would be self-justifying and the policy of intervention would be not a stabilising factor but a destabilising one."

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This is, of course, a description of the dangers of moral hazard. Kay likens what people do when they are insured against – or oblivious to – catastrophe as "tailgating". Anybody who has driven on the highspeed autobahn in Germany or highways in France and other European countries has likely experienced what happens if you drive at only moderately high speed in the left lane. Almost immediately a car will zoom up behind you, flashing its lights and pushing its nose close to your car's rear end. You will briskly move back to the right lane for fear of what may happen. These tailgaters gain by saving a little time, but they risk disaster.

Suppose they were somehow insured against that disaster – perhaps, a skyhook would somehow appear above them and yank them from the scene before an accident occurred. Then they would be even more abandoned about pushing others off the road. And they would save even more time. But who would pay for the skyhook?

When financial industry participants make risky bets that could sink their companies – not to mention other collateral damages – they are in effect borrowing against the next bailout. Kay quotes Nassim Taleb, "'their profits were simply cash borrowed from destiny with some random payback time'.

In a Skype interview, I discussed this with Professor Kay. We conjectured about what it might mean when the US Treasury says it has actually made money on the TARP bailout. Our tentative conclusion was that the profit it made was merely borrowed against the next bailout.

It is obvious that this pattern can't continue forever. Eventually, we will have the problem – if we don't already – of what to do about major governments themselves that are "too big to fail."

4. THE SOLUTIONS

Kay describes the solutions he favors for each channel – the deposit channel and the investment channel.

4.1 The deposit channel

For the deposit channel, Kay's solution is one that has been favored by many others – to ringfence – that is, to separate – the deposit channel from the risky trading activities that occur currently elsewhere in a financial institution. This could take the form of the Volcker rule – separating proprietary trading from the deposit channel – or restoration of the Glass-Steagall Act that separated investment banking from commercial banking and other such provisions.

The all-important payments system that operates through the deposit channel should be safeguarded, as it is now, by deposit insurance. But government intervention should be limited to that. When a bank or other financial institution fails, the solution is not a bailout to save the institution, but resolution under government supervision to restructure it, as with a bankruptcy.

But, as Kay also notes, "The origins of the problems that rightly concern the public are to be found in the structure of the industry and in the organisation, incentives and culture of financial firms."

He says, "The ethical standards associated with parts of the finance sector are deplorable." He then presents this startling, but true comparison:

> "Parts of the finance sector today... demonstrate the lowest ethical standards of any legal industry. If London casinos were ever accused of the malpractices to which London banks have admitted – false reporting, misleading customers and unauthorised trading – the individuals responsible would be barred from the industry and the licences of the institutions concerned revoked within hours."

Something must be done about this culture of appallingly low ethical standards. Prosecution of individuals, shaming and widespread condemnation are appropriate. But, as Kay notes, "The finance sector spends more on lobbying than any other industry. In the US, its expenditures in the 2012-2014 election cycle totalled US$800 million, with another $400 million spent on campaign contributions. There are about 2,000 registered finance industry lobbyists in Washington; about four for each member of Congress."

Kay quotes Truman biographer David McCullough: "... when Harry S Truman [stet[1]] left office 'his name was not for sale. He would take no fees for commercial endorsements, or for lobbying or writing letters or making phone calls'."

Is it even vaguely possible to restore that level of ethical standard to public service?

4.2 The investment channel

Most interesting and truly revolutionary given today's practices – and most difficult to achieve, at least in the US – is Kay's solution for the investment channel.

In the asset management field, the requirement for "transparency" has been limited largely to utterly useless pursuits such as marking the value of a portfolio to market every day, accompanied by a massive charade of manager selection, monitoring, oversight and evaluation. If in the name of transparency the value of the assets must be capable of being reported every day, then only large companies that are actively traded on the secondary market can be included in managed portfolios. This is, of course, the current bias of almost all investment management firms.

To justify the high fees that these firms are able to charge because of information asymmetry, there is a "bias to action" that promotes constant trading. But the value to the real economy is negative. Paradoxically, while trading on the secondary market increases, the actual need for capital on the part of large listed companies has declined. Corporate activities are less capital-intensive than in the days when the US economy was manufacturing-driven and based on iron, steel and concrete. Thus, says Kay, "A paradox of financialisation is that the need for an active share market has diminished at the same time as the volume of trading has grown exponentially."

This incessant trading of secondary market shares, with little connection to the needs of the actual companies has promoted an industry of monitoring, evaluation and supposed management of a largely irrelevant measure, namely comparison of the asset manager's rate of return to a benchmark. It has promoted the drawing of senseless equivalences such as the identification of risk with tracking error.

Kay's solution to this situation is one that will seem - and is - very distant from the current situation (unless, that is, you are a citizen of Germany).

The solution, to put it one way, is for asset managers to become like a fleet of specialised Warren Buffetts, investing directly in (mostly) small to medium-sized companies without regard to - or that do not have - a daily stock price on the secondary market.

Under this prescription, each asset manager would specialise in a small number of companies and buy equity or lend to them directly. The secondary market - that is, the securities market as we know it— would be little needed, and perhaps would wither, as Kay believes it should. "The objective," he says, "should be to reduce trading volumes to the modest levels that serve the real needs of the non-financial economy." That would be a reduction by several orders of magnitude.

I say this solution will seem very unusual unless you are a citizen of Germany, for a reason. Kay gives a truly enlightening account of the economy of Germany, one that I have been waiting to learn for quite some time. Germany has undertaken an extremely costly "energy transition" (Energiewende), leading the world in the development of renewable energy. It has made losing loans to Greece and other southern European countries and contributed to the Greek bailout. It has lost large sums of money that its banks, with their "too-high" ethical standards and credulity (see, for example, Michael Lewis's book, Boomerang), invested in high-credit-rated, low-quality CDOs. It has agreed to take in thousands of refugees. And, it has spent money lavishly in other ways. And, yet, its economy is one of the most vibrant in Europe and in the world.

How does it do it? Kay describes, "the Mittelstand, the small- and medium-size companies that are the basis of Germany's extraordinary strength in manufacturing exports. German exports per head are four times those of the USA and more than ten times those of China. The businesses of the Mittelstand are predominantly family-owned."

How are these companies financed? By "the co-operative and savings bank sector, which provides around two-thirds of lending to the Mittelstand... the German banking system has funded what is certainly the most effective SME [small- and medium-sized enterprise] sector in Europe and, possibly, the world... In Britain and the USA, successful medium-size businesses grow by acquisition or are themselves acquired. But this 'hollowing out' of the middle of the size distribution of companies has not occurred in Germany."

Hence, Kay concludes, "Perhaps the most useful initial role for government is to promote the creation of new financial institutions directed to providing the mix of loan and equity finance and advice needed to help SMEs grow. That development should be conjoined with a brief for asset managers that is less focused on public markets."

In his understated linguistic manner, John Kay has proposed what would be the most revolutionary reconfiguration of the financial sectors in the US and UK that could be imagined, other than a Communist takeover – which it does not in the least resemble. And yet, it is truly what is needed.

Let us hope that not everyone has been so blinded by the community of modern financial intermediaries – which creates a frenzy of activity and excitement by trading mostly with itself – that they do not see that a solution such as this one must be found, and implemented, very soon.

ENDNOTES

[1] Truman's full middle name was "S".

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