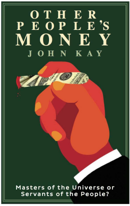

Kay J. Other People's Money

Modern societies need finance. A country can be prosperous only if it has a well-functioning financial system, but it is possible to have too much of a good thing. Finance has gained a dominant economic role. Much of the growth of the finance sector represents the appropriation of wealth created elsewhere for the benefit of the people who work in the financial sector.

The world of finance today is dominated by trading. The change in the nature of finance had little to do with any change in the needs of real economy. Anonymous market has replaced personal relationships.

Trading-oriented financial sector was closely associated with the free-market ideology, that is not the product of deep intellectual conviction but a pragmatic alliance of convenience. Modern financial economics treats risk as a commodity, laying bets on the interpretation of incomplete information and the socialization of individual risks. Market for securities is based on differences in informations or perceptions of informations, markets for other commodities are based on differences in preferences and capabilities. Finance can be inordinately profitable and that profitability can have no relation to the value added from financial activities. For the most part the risk transfer doesn't represent an insurance rather wagering, the risks are generated within the financial system and do not impinge on Main Street.

The transition from agency to trading brought that most of the transactions are trades made through agents. Markets are anthropomorphized, replacing knowledgeable intermediation with the wisdom of crowds. The ability to compile and analyze large database can improve our understanding but must complement, not replace, the traditional and still indispensable inter-personal skills. The liquidity that the speculator provides to the market with trades in volume every millisecond, increase the volatility of prices but is an illusion because it is not available when it is needed and doesn't improve the activities of long-term investors. Only intervention by governments could provide patient capital, but aggravates moral hazard. Large corporations today operate in many business sectors and are global in their scope. The value of their assets are correlated and the diversification of the investments is now not easy. High leverage provides opportunities for gamblers and tailgaters with other's people money and creates many opportunities to fall victim to the "winner's course".

As the value horizon has lengthened, with business becoming more complex, the performance horizon has shortened. The guidance and management became more divorced from the underlying realities of business. Regulation is often the enemy of competition: firms will behave similarly; consumer will be reluctant to switch provider. Financial services companies are generally one more step ahead of the regulator and can profit by regulatory arbitrages. The outcome is a regulation that become progressively more complex but which is rarely more effective. Profits are measured quarter by quarter, but the time-scales of business project are usually much longer and often longer than the tenure of the officer responsible for them ("I'll be gone, you'll be gone"). The accounts of financial institutions are still opaque and not conservative. Estimate of future gains are registered as current trading gains ("mark to market"). But if there is no market you might estimate what the price would have been if there had been a market ("mark to model"). And traders are prone to temporary fit of shared enthusiasm. They have herd instinct and self-referential values and practices that reinforce false beliefs. The large financial conglomerates are run for the primary benefit of the people who manage them and they survive as a result of public subsidy. Governments are become tailgaters.

Institutional inertia can slow technological change in the payment system, but can rarely prevent it altogether. The complete dematerialization of payments potentially deprives governments and established banking institutions of their traditional mechanism of control. It is improbable that in fifty or twenty years from now the deposit channel will have the central role in the financial system by virtue of its link to payments. The payments system is ripe for disruptive innovation. It will become an inexpensive utility distinct from the deposit channel.

Regulation of finance fails to satisfy demands and expectations. It is at once too extensive and intrusive and largely captured by industry interests and ineffective in achieving public policy goals. There is too much government involvement. What was described as a process of deregulation led in practice to a massive increase in the scope and burden of regulation. Model of supervisory regulation (risk weighting, securitization) actively contributed to regulatory, accounting and fiscal arbitrages, to which has been responded with the proliferation of more complex rules. The focus of regulation on the security market has shifted from protection of the consumer to protection of the market: transparency has let to provision of more and more material of little or no value to users. Consumers rely on reputation of the suppliers. Regulation

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by Valerio Carnovale

would focus on the integrity of finance providers rather than the integrity of the markets. The Basel calculations of capital adequacy became a substitute for the prudential management of the risk. Bank executives expanded their balance sheet to the limits permissible by regulation. Light touch regulation was the product of the demand of industry transmitted through political process. Financial regulation is comprehensively captured. There has been little change in the behavior of the industry, with the result that successive crisis are more or less inevitable. The large sums of public money released in the financial system have done little to promote economy recovery since the funds provided were largely retained within the financial sector itself or paid out in excess remuneration to senior employees. There is a requirement to maintain the integrity of the payment system and the principal vehicle for this purpose is deposit protection. The use of public money should be limited to that purpose and the official reaction to the failure of a financial institution should be resolution, not recovery; the deposit-taking functions in the financial conglomerates should be financially and operationally separate from the others activities. Deposit-taking banks require close regulation. They access the payment system and hold the everyday savings of ordinary people. The natural vehicle for the saving of depositor are government borrowing and good-quality housing loan. Consumer protection in finance should rely on reputation, an industry that would be deserving of confidence.

The origins of the problem are to be found in the structure of the industry and in the organization, incentives and culture of the financial firms. "More regulation", exemplified by the multiplication of the length of the Basel rulebook, will provide only the appearance of action. Securing the stability of the existing institutions is a short-term response and ossify the structure of the system. Systemic instability is the result of interdependencies inherent in an industry that deals mainly with itself. Financial intermediation has to compete to meet the needs of the real economy. The guiding purpose of the legal and regulatory framework should be to impose and enforce the obligation of loyalty and prudence with the management of other people's money. Regulation based on detailed prescriptive rules has undermined, rather than enhanced, ethical standards, by substituting compliance for values (self-regulation plainly failed). Finance needs a different industry structure and other personal and corporate incentives, so that putting client first, leads to personal reward and business profit in the long run. The trading culture need to reduce the volumes to the modest levels that serve the real needs of the non-financial economy. The Tobin tax cannot be imposed on global basis. A preferable strategy is structural reforms that will reduce the amount of capital available to support trading. The following principles should underpin reform:

1. Chain intermediation should be short, simple and linear (link between market participants are too numerous and with savers and users of capital are too few and too weak). The increase in the size of financial institution led by financialization can enhance stability, but the central problem is the complexity: no one can ever be confident of anticipating the full variety of interactions that will be involved, stability and resilience require conscious and systematic simplification, modularity and redundancy. Robust systems are typically linear that permit rapid identification and isolation of the problems;
2. Focused and specialized institutions with direct links to financial users should be restored, so that the financial system becomes resilient and directed to the needs of users of financial services. The overriding objectives are to reduce complexity, lower costs, enhance stability and facilitate the flows of information between savers and borrowers. The financial conglomerates are largely indistinguishable from each other and have similar business models partly the result of over-extensive regulation which impose "one size fits all". Their objective is to outstrip rivals. The policy objective should be to restore a linear framework of intermediation between depositors and borrowers.
3. Anyone who handles other people's money, or advise them, should demonstrate behavior that meets standards of loyalty and prudence in client dealing and avoid conflict of interest. It is indispensable to ring-fence the deposit channel to ensure that the operations of payment system cannot be jeopardized by the failure of financial conglomerates. The subsidy to trading activity arising from the availability of the deposit base as collateral should be removed and financial conglomerates are to be fragmented because financial intermediaries can act only as custodian of other people's money or trade with their own money. Current investment banking model is at the hearth of the problem. Asset manager should occupy the central role in the investment channel with long-term horizon. Personal responsibility is vital to reform;
4. Behavior standards should be enforced by criminal and civil penalties directed primarily to individuals. Enforcement should be aimed at responsible individuals, not corporations, and convictions should be easier to secure. The individuals are responsible for what happens under their supervision. Period. Such measures will deter people from accepting position of responsibility without the burdensome obligation involved in handling other people's money.
5. Government should treat financial services as an industry like any other, regulation should be targeted at deposit protection, consumer abuse and prevention of fraud, and government support should be withdrawn;
6. The financial sector should not be used as an instrument of economy policy.