Institute of Policy Studies

IPS Corporate Associates Breakfast: "Other People's Money"

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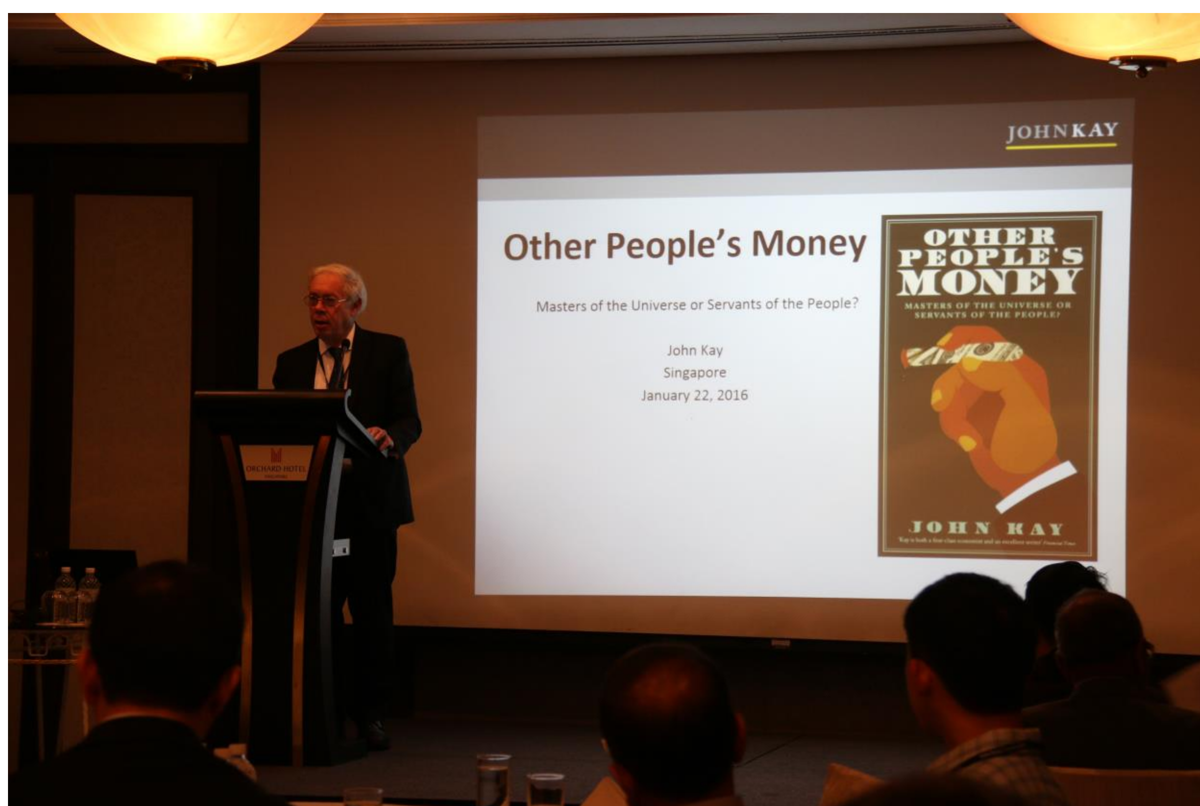


Economist and *Financial Times* columnist John Kay visited Singapore last month as part of a promotional tour for his latest book *Other People's Money*. The book examines the nature of finance and the origins of financialisation, and proposes reforms that could foster a financial industry and meet the needs of the real economy. Both the media company Bloomberg and *The Economist* magazine named *Other People's Money* as one of the best books of 2015.

Professor Kay, who is a Visiting Professor of Economics at the London School of Economics and Political Science, and a Fellow of St John's College at the University of Oxford, spoke at a specially arranged IPS Corporate Associates (CA) breakfast meeting to an audience of around 40 members of CA companies and IPS staff.

He began by noting that the financial sector has become increasingly divorced from its real functions within the economy. The sector increasingly "talks to itself and trades with itself",

he said. The volume of foreign exchange trades has expanded much faster than global trade volumes over the past 30 years. The total volume of exposures in derivatives contracts amounts to US$700 trillion, roughly three times the volume of all assets held in the economy. This culminates in activities of little real benefit to society, such as the recently built fibre-optic cable between Chicago and New York City, which was aimed at reducing transmission times for algorithmic trades from 7.3 milliseconds to 6.6 milliseconds. It was built at an estimated cost of US$300 million. In the United Kingdom, lending to small firms accounts for less than 3% of the balance sheets of major banks.

For Prof. Kay, the financial sector should serve four broad functions in the real economy. First, to facilitate payment through the creation and operation of payment systems; second, wealth management to fund education and retirement, to spread consumption and savings, and to pass on assets to the next generation; third, capital allocation to match investments with business ideas; and fourth, risk mitigation to pool and diversify risks to create a secure environment through risk-sharing.

Prof. Kay noted that technological innovation and disruption would reshape payment systems, such as retail bank deposit systems and paper cash. He also noted that the role of public markets in capital allocation has changed. In the early stages of the 20th century, the stock market developed in the United States to provide funding to capital-intensive industries like railroads, manufacturing plants and breweries. However, net equity issuance in the US and the UK has been negative over the past 20 years, and stock market listings now primarily serve to provide liquidity for private early-stage investment exits. He said: “[Public markets] serve not to put money into markets, but to take money out,” adding that this is in line with the growth of privately funded, asset-light business models, where intangible assets like market position, brand and expected profits account for increasing shares of market capitalisation.

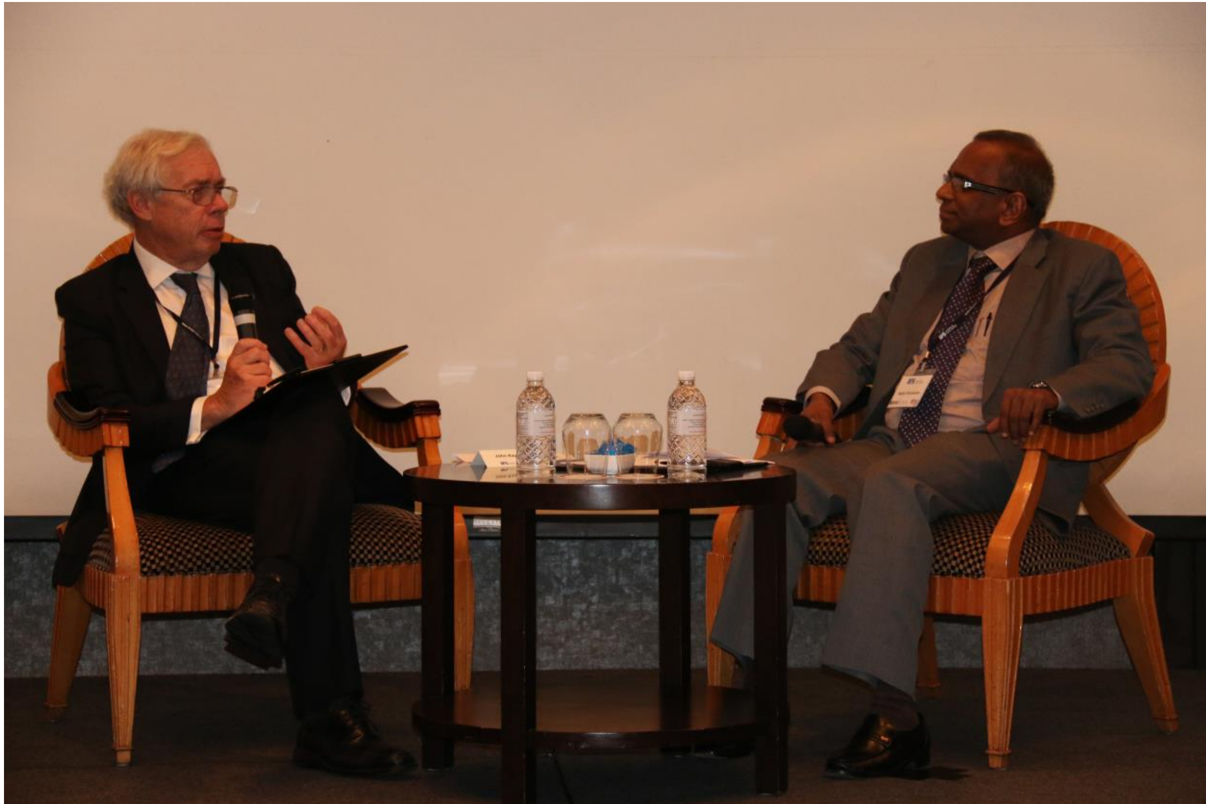
Prof. Kay also gave examples of how risk mitigation in the past had become risk concentration today, using the example of Lloyd’s Coffee House in London. In the 17th century, it was the world’s centre for the global maritime insurance industry and there, lead underwriters with specialist knowledge of particular risks would underwrite risks. But in the 1980s, underwriters began writing reinsurance contracts where the underlying risks could not be defined, and re-insured reinsurance contracts ad infinitum, leading to impossible-to-calculate risks. Insurers found themselves reinsuring risks of accidents many times over during accidents like the Piper Alpha oil rig explosion.

The 2008 Financial Crisis was another example. It arose from a combination of misaligned incentives and structures, poor morals and leadership, and behavioural biases both within industry and public institutions. Serious and widespread breaches of trust and ethics were made by the financial industry in the past decade, and Central Banks and regulatory agencies collectively failed to accurately assess the risks posed by the build-up and securitisation of subprime mortgages.

Prof. Kay categorically stated that more regulation was not an answer, because regulation generates its own complexity and would create the need for more financial products, generating a vicious cycle of regulation, financialisation and risk. For example, the credit

default swap was created in response to demand for regulatory arbitrage between insurance and loan markets. Better regulation should focus not on prescriptive rulebooks but better alignment of industry structures, as well as corporate and individual incentives to long-term social benefits.

Question and Answer Session



IPS Adjunct Senior Research Fellow Manu Bhaskaran moderated the Q&A. He began by asking about regulatory capture — which occurs when a regulatory agency set up to act in the public interest ends up advancing the interests of groups who dominate the industry it is tasked to regulate. Prof. Kay replied that regulatory capture remains an obstacle to solving the problems highlighted above, and the influence on Wall Street financing is far greater now than it was in the 1930s.

The revolving door between financial institutions, central banks, and politicians continues to influence policy, he said, pointing out that in the UK, central bank executives and finance industry executives attended the same graduate schools and this led to a convergence of views about the financial economy that proved erroneous. Extremely skewed earnings within the financial sector — with the top 1% of bankers receiving remuneration that may collectively surpass what a significant percentage of other employees receive has contributed to skewed returns in the economy. In addition, the high concentration of capital in a small group of like-minded managers has contributed to market herding. These conditions have led to unfocused public anger against the financial sector, and support for extremist views in politics on the left and right have grown.

Participants expressed pessimism on the ability of regulations to change an industry rife with a culture of greed and competition. A participant said that the 2008 crisis was fundamentally a "moral crisis", which remained unexamined within the industry. Instead, regulators were blamed. Another participant questioned the absence of calling out of irresponsible individuals within the sector. Prof. Kay noted that "effectively operating markets operate within a social context that fosters trust and cooperation… [This] functions in a value and cultural context, which [is] as important as the markets themselves." Prof. Kay suggested that one method of reform is to impose serious personal liabilities at the very top of organisations.

However, he also expressed doubt about the ability of regulation to force people to do things that they do not want to do, and noted that values and cultures do not change through codes, practices or regulation. Real reform requires a collective understanding that corporations are not channels for individual greed but a means of creating goods and services for the community; and it also involves the creation of structures that align rewards with actual social benefits. Economists have been responsible for creating models that ignore this aspect of economies. More active stewardship by asset managers to align management actions with long-term benefits, and greater focus on fundamental value rather than speculation was recommended.

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