

Buttonwood

Time for a rent cut

Controlling the finance sector's excess returns

Jun 3rd 2010



WHY do people who work in finance earn more than most other people? It is a question that concerns politicians, as they debate reform of the industry. It ought also to worry those millions who, as savers and borrowers, are consumers of the industry's products.

Something has clearly changed within the past 40 years. Banking and asset management used to be perceived as fairly dull jobs, which did not attract a significant wage

premium. But after 1980, financial wages started to climb much more quickly than those of engineers, another profession that ought to have benefited from technological complexity.

Around the same time, banks became more profitable. Andrew Smithers of Smithers & Co, a firm of consultants, points out that the return on equity achieved by British banks averaged around 7% between 1921 and 1971; since then it has averaged around 20%.

Such a sustained rise suggests that the finance sector has been able to extract "rents", a term that economists use to explain excess profits. But that suggestion only raises another question; why haven't those rents been competed away?

Barriers to entry are a standard explanation for an uncompetitive market. In the case of banking, these barriers may exist in the form of the implicit subsidy provided by government support; this lowers the cost of finance for leading institutions. In March Andrew Haldane, executive director for financial stability at the Bank of England, argued that the effective annual subsidy for the five biggest British banks during the credit crunch was more than £50 billion (\$73 billion), roughly equal to the whole industry's annual profit in the years before the crisis.

As evidence of the industry's lack of competition, Mr Smithers points to its increasing concentration. The proportion of bank assets held by the three biggest American banks has tripled since 1994. It is far from clear that this concentration is healthy for the rest of the economy; Mr Haldane cites research showing that

economies of scale peak when banks have \$5 billion-10 billion of assets.

The big banks may have benefited from other factors apart from a lower cost of capital. In market-making, for example, size gives banks an advantage since they have more knowledge of institutional investors' order flow and can position themselves to benefit.

In addition, the growth of the financial industry has coincided with the move to floating exchange rates and market liberalisation. The result has been the creation of a whole series of instruments, mainly derivatives, designed to deal with the risks of interest-rate and currency movements. The more complex the product, the less transparent it is to customers; that makes it harder to judge the price they are being charged. The surge in trading volumes is also significant; at every stage the finance industry takes a cut in the form of a bid-offer spread, a fee or a commission. This churning is a classic rent-seeking activity.

What to do about it? At the moment, governments are wading in with all kinds of levies and regulations, which will probably have unintended consequences. Rather than tackle the big problem (for example, by breaking up the banks), they waste their time on populist measures like banning short-selling.

It would be far better if the private sector could deal with the problem. Paul Woolley, a former fund manager who set up centres for studying capital-market dysfunctionality at the London School of Economics and the University of Toulouse, has published a manifesto which he believes should be adopted by the world's biggest public, pension and charitable investment funds.

Among other things, he proposes that the funds should adopt a long-term investment approach, cap annual portfolio turnover at 30%, refuse to pay performance fees or invest in alternative assets such as hedge funds and private equity, and invest only in securities traded on a public exchange (so no structured products like the infamous collateralised debt obligations).

Some will argue with the details but the thrust of the argument is simple. If the big funds in effect own the market in aggregate, then frenetic trading activity is fruitless, even before costs. Perhaps they are chasing a chimera: they all wish to be above-average performers. Perhaps they are bamboozled by an asset-management industry that competes not on price but on the basis of (probably unrepeatable) past performance. Whatever the reason, the effect is that the returns that millions of savers hope to earn end up being paid to the finance sector as rents.