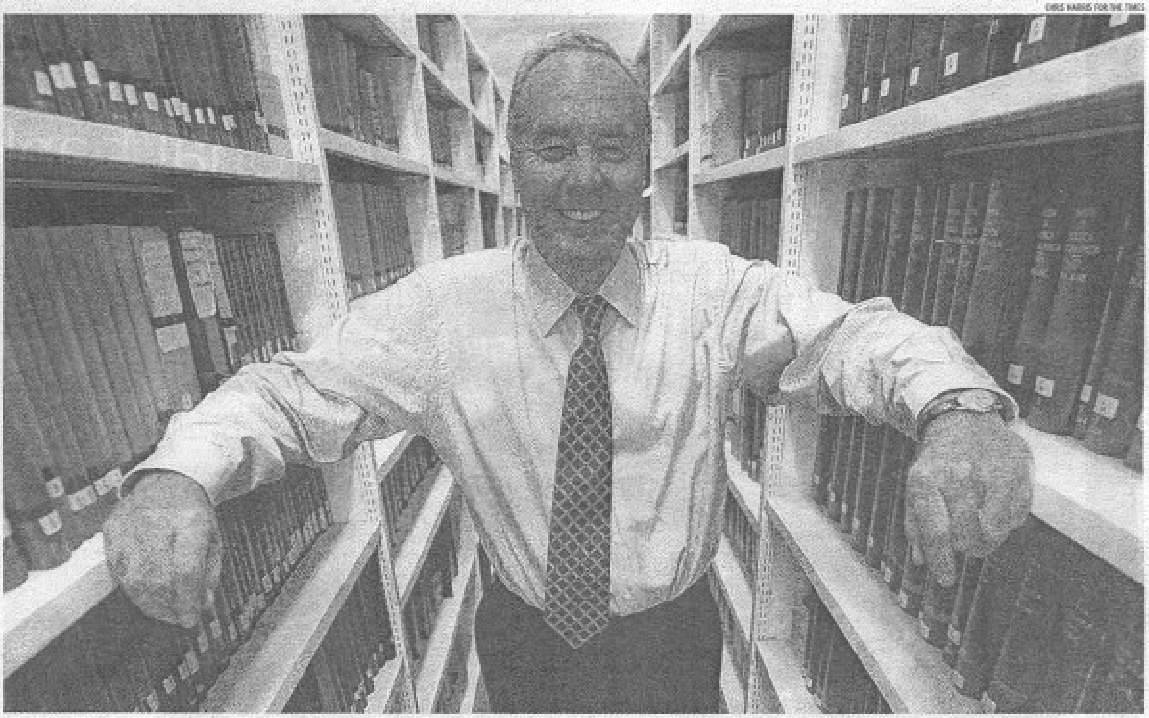
The man who fuelled Turner's City attack

Paul Woolley, a banker turned academic, is challenging the basis of the financial industry, writes **Patrick Hosking**



CHRIS HARRIS FOR THE TIMES

Paul Woolley, of the Centre for the Study of Capital Market Dysfunctionality, believes that "nothing will ever be the same again in the theory of finance"

Paul Woolley is an unlikely revolutionary. With sober suit, silk tie and measured, thoughtful delivery, he looks and sounds like a retired City gent. Which is exactly what he also is. He was a banker with Barings years before that bank's implosion and then founded the London arm of GMO, the American fund management group.

Now an academic, Dr Woolley is investing £4 million of his personal fortune to bankroll a London School of Economics unit whose research questions the very purpose of the City and challenges some of its most deep-rooted beliefs.

It was Dr Woolley's research that underpinned the explosive assertion last month by Lord Turner, chairman of the Financial Services Authority, that some banking was "socially useless", that the City had grown too big and needed to be cut down to size and that its profits and bonuses were excessive.

That drew a furious response from the Square Mile, one echoed by Boris Johnson, the Mayor of London, who called it "crackers", and Richard Lambert, Director-General of the CBI, who urged Lord Turner to shut up.

Dr Woolley is unrepentant. "I'm a free markets man," he said. "I'm not a Trotskyite. But the truth is markets [in finance] do not work. Everyone can be individually acting rationally and optimally, but the collective outcome can be catastrophic, a complete Horlicks."

Dr Woolley's LSE unit, the Centre for the Study of Capital Market Dysfunctionality, is proving a thorn in the side of bankers, brokers, asset managers and City advisers who would like a return to business as usual after the two years' upheaval.

His team have come up with some uncomfortable theories about how capital markets really work. They overturn the orthodoxy of the past century and more — that markets are more or less efficient, that capital is allocated optimally and, by extension, that a mushrooming finance industry is good for Britain.

In the City, this is profoundly disturbing. Efficient market theory is the foundation that supports the entire multitrillion-pound edifice of trading. Dr Woolley balks at the suggestion that he is some latter-day Darwin exploding the comfortable orthodoxy of the day. "For God's sake, don't write that," he says, before conceding that his view of the financial world is indeed radical and profound.

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"This bloody well changes everything," he says. "Nothing will ever be the same again in the theory of finance. It is going to have a huge impact, I think."

Could the intellectual ballast provided by Dr Woolley's team really change the way the world sees financial services? Could they really alter working practices in the City and on Wall Street? Perhaps. "People suddenly get what we're doing," Dr Woolley says. "They are starting to cotton on."

After retiring from GMO, Dr Woolley set up his centre in 2007, weeks before the credit crunch struck. He has some heavyweight supporters. Sir Howard Davies, the director of the LSE and a former FSA chairman, sits on his advisory board. Mervyn King, Governor of the Bank of England, was guest of honour at the launch dinner.

Initially, the LSE opposed the word "dysfunctionality" in the centre's name as too provocative and asked for it to be toned down to "inefficiency". Dr Woolley stuck to his guns. "I really felt 'inefficiency' was too mealy-mouthed a word." Within two months of the centre opening, wholesale credit markets seized up completely, sending capitalism into its biggest funk in 80 years; within four months, Northern Rock failed. Suddenly, "dysfunctionality" seemed very much the *mot juste*.

At the heart of the centre's work is the recognition that capital markets do not operate as classical economics supposes. Traditional theory is based on the idea that investment decisions are made by an infinite number of self-interested, rational households.

That is bunkum, Dr Woolley argues. The reality is that investment decisions are taken by their agents — fund managers, who have different priorities and enjoy access to better information. "Incredibly, the academics fail to take into account the agency problem," Dr Woolley says.

It is a problem that permeates financial services. Agents — fund managers, pension fund consultants, bankers, brokers and company directors — all stand between assets and their beneficial owners. Quite rationally, they behave in ways not in the interests of their clients.

Their presence is highly distortive, raising the cost of capital and drastically shrinking investment returns. Dr Woolley estimates that without the agency problem, private sector pensions could be twice as large. "And that's probably being conservative."

People who laud the huge size of the City as evidence of its success have got things competely about-face, Dr Woolley argues. "It's testament to the malfunctioning of markets, not their efficiency," he argues.

Dr Woolley, 69, who was with the IMF in Washington before entering fund management, rejects suggestions that the finance industry, for all its faults, should be supported because it is so important to the UK economy. Britain has put too many of its eggs in the financial services basket, he believes. "Now it needs to lead the world in taming the monster that has been created," he says. "It [the present order] might last for another five or ten years, but we're on borrowed time now."