

The Future of Finance: The LSE Report

What is the financial system for? What is the future of finance?

This report presents a novel approach to the reform of the world's financial system, starting with the basic question, what is a financial system for? It shows that the existing system has become far more complicated than it needs to be to discharge its functions – and dangerously unstable into the bargain. It proposes some drastic remedies.

The Future of Finance: The LSE Report is the work of a group of leading academics, financiers, journalists and officials from the UK's Financial Services Authority, the Bank of England and the Treasury. They met twelve times, for what many of those present described as the best and most searching discussions they had ever participated in.

Chapter 1

What do banks do?

Why do credit booms and busts occur and what can public policy do about it?

- Adair Turner -

Over the last 30 to 40 years the role of finance within developed economies has grown dramatically: debt to GDP ratios have increased, trading volumes exploded, and financial products have become more complex. Until the recent crisis this growing scale and complexity were believed to enhance both efficiency and stability. That assumption was wrong. To understand why, we need to recognise specific features of financial markets, credit contracts, and fractional reserve banks. The recent crisis was particularly severe because of the interaction between the specific characteristics of maturity transforming banks and securitised credit markets. The regulatory response needs to distinguish the different economic functions of different categories of credit: only a fraction of credit extension relates to capital formation processes. The response should combine much higher bank capital requirements than pre-crisis, liquidity policies which reduce aggregate maturity transformation, and counter-cyclical macro prudential tools possibly deployed on a sectorally specific basis.

Chapter 2

What is the contribution of the financial sector:

Miracle or mirage?

- Andrew Haldane, Simon Brennan and Vasileios Madouros -

This chapter considers the contribution made by the financial sector to the wider economy. The measured GDP contribution of the financial sector suggests it underwent a “productivity miracle” from the 1980s onwards, as finance rose as share of national output despite a declining labour and capital share. But a detailed decomposition of returns to banking suggests an alternative interpretation: much of the growth reflected the effects of higher risk-taking. Leverage, higher trading profits and investments in deep-out-of-the-money options were the risk-taking strategies generating excess returns to bank shareholders and staff. Subsequently, as these risks

have materialised, returns to banking have reversed. In this sense, high pre-crisis returns to finance may have been more mirage than miracle. This suggests better measuring of risk-taking in finance is an important public policy objective - for statisticians and regulators, as well as for banks and their investors.

Chapter 3

Why are financial markets so inefficient and exploitative – and a suggested remedy - Paul Woolley -

The chapter offers a new understanding of how financial markets work. The key departure from conventional theory is to recognise that investors do not invest directly in securities but through agents such as fund managers. Agents have better information and different objectives than their customers (principals) and this asymmetry is shown as the source of inefficiency - mispricing, bubbles and crashes. A separate outcome is that agents are in a position to capture for themselves the bulk of the returns from financial innovations. Principal/agent problems do a good job of explaining how the global finance sector has become so bloated, profitable and prone to crisis. Remedial action involves the principals changing the way they contract with, and instruct agents. The chapter ends with a manifesto of policies that pension funds and other large investors can adopt to mitigate the destructive features of delegation both for their individual benefit and to promote social welfare in the form of a leaner, more efficient, and more stable finance sector.

Chapter 4

What mix of monetary policy and regulation is best for stabilising the economy? - Sushil B. Wadhwani -

We argue that the attempts to exonerate the conduct of monetary policy from a role in the crisis are unconvincing. We offer several reasons why macro-prudential policy may be less effective than monetary policy and suggest that the two policies need to be set jointly. Hence, the current plan to separate them in the UK should be revisited. In contemplating regulatory change, it is also important to recognise that financial innovation has played a central role in economic growth over time, and to also be aware that mistakes made by regulators contributed to the crisis. A more appropriate macroeconomic stabilisation framework may help reduce output volatility by more than regulatory micro-meddling. The latter may hurt growth or not work anyhow. Indeed, in some countries (e.g. China, India), more financial liberalisation would stimulate growth and help reduce global imbalances.

Chapter 5

How should we regulate bank capital and financial products? What role for “living wills”? - Charles Goodhart -

Financial regulation is normally imposed in reaction to some prior crisis, rather than founded on theoretical principle. In the past regulation has been deployed to improve risk management practices in individual banks. This was misguided. Instead, regulation should focus first on systemic externalities (contagion) and second on

consumer protection (asymmetric information). The quantification of systemic externalities is difficult. Since the costs of financial breakdown is high, a natural response is to pile extra regulation onto a set of regulated intermediaries, but this can impair their capacity to intermediate and leads onto border problems, between regulated and unregulated and between different national regulatory systems.

Chapter 6

Can we identify bubbles and stabilise the system?

- Andrew Smithers -

In addition to low inflation, central banks must aim to avoid major recessions. They must therefore seek to moderate bubbles, because asset prices are an important transmission mechanism whereby changes in interest rates affect demand in the real economy. Interest rate changes move the prices of assets away from fair value, but their impact is ephemeral. If bubbles are allowed to form, they will break and asset prices will continue to fall even if interest rates decline sharply. Central banks are then unable to stimulate demand. The severe recessions which result, require, as we have recently seen, large fiscal stimuli. The recessions are damaging and the deficits reduce our ability to cope with future crises. At present there is no adequate institutional structure for monitoring the asset bubbles and financial excesses and for taking action to moderate them. The Government's proposed creation of such a structure is thus essential and welcome.

Chapter 7

What framework is best for systemic (macroprudential) policy?

- Andrew Large -

This chapter identifies a significant gap in today's economic/financial policy framework and suggests for debate an approach to fill it. It addresses systemic financial failure which, as recent events have amply demonstrated, can give rise to significant fiscal and welfare costs. Seeking to prevent such failures has encouraged a plethora of regulatory initiatives. This chapter suggests that, important though they may be, they will not on their own prevent crises. It proposes a policy framework for containing systemic dangers but recognises that there are a number of significant and difficult issues on which at present there is no clear-cut conclusion. Important interfaces with other policy areas – such as monetary and regulatory – are considered. Encouragingly the policy debate and increasingly political intentions in both Europe and the US do now seem to be focussing on these issues and the new UK government has announced its plans to move in this direction.

Chapter 8

Should we have “narrow banking”?

- John Kay -

The credit crunch of 2007-8 was the direct and indirect result of losses incurred by major financial services companies in speculative trading in wholesale financial markets. The largest source of systemic risk was within individual financial institutions themselves. The capital requirements regime imposed by the Basel agreements both contributed to the problem and magnified the damage inflicted on the

real economy after the problem emerged. The paper argues that regulatory reform should emphasise systemic resilience and robustness, not more detailed behaviour prescriptions. It favours functional separation of financial services architecture, with particular emphasis on narrow banking – tight restriction of the scope and activities of deposit-taking institutions.

Chapter 9

Why and how should we regulate pay in the financial sector?

- Martin Wolf -

This chapter investigates whether there is a case for regulation of financial sector pay and, if so, how it should be done. It concludes that regulators should not be concerned with the level of pay. That should be left to tax policy, though there is also a strong case for investigating the degree of competition in the sector and exploring remedies if significant monopolies are discovered. But regulators do have a vital interest in the structure of pay, since shareholders and managers can benefit from gaming the state's role as insurer of last resort of these highly leveraged and so inherently risky businesses. Structural reforms, including much higher capital requirements, would help. But, so long as anything like the present situation prevails, in terms of the structure of the financial industry, it is vital to prevent management of systemically significant institutions from benefiting directly from decisions that make failure likely. The answer is to make decision-makers bear substantial personal liability, in the event of such failures.

Chapter 10

Will the politics of global moral hazard sink us again?

- Peter Boone and Simon Johnson -

During the last four decades governments in wealthy countries have built up large contingent liabilities due to the implicit guarantees they have provided to their financial sectors. Politicians are motivated to create near term growth and always reluctant to permit hardships that would otherwise arise from defaults and greater austerity. As a result, the industrialised world has experienced excessive and dangerous financial sector development. Including all promises, U.S. and European taxpayers back over 250% of their GDP in implicit obligations, all of which contribute to the development of moral hazard in lending around the world. If this incentive system remains in place and these liabilities continue to grow unchecked, the eventual end of this “Doomsday Cycle” – with repeated bailouts for distressed lenders – will be large sovereign defaults and economic collapse. The current round of regulatory reform is not sufficient to stop this trend.

Appendix - biographies

Dr Paul Woolley's career has spanned the private sector, academia and policy-orientated institutions. After several years of practical experience in a firm of stockbrokers, latterly as a partner in his firm, he studied Economics at the University of York (UK) receiving BA (1970) and D Phil (1976). He held the Esmée Fairbairn Lectureship in Finance at York 1970-76, also serving as Specialist Advisor to the House of Lords Committee on the EEC 1975-6. He then moved to the International Monetary Fund 1976-83, initially as an Economist and later as Advisor and then head of the Division responsible to the Fund's borrowing and investment activities. Returning to the UK, he was for four years a Partner and Director on the main board of merchant bank, Baring Brothers and its various subsidiaries. In 1987 he co-founded, and was Managing Director of, GMO Woolley, the London affiliate of GMO, the Boston-based fund management firm. He was a Partner and served on the main GMO board (1998 – 2003). He retired as Chairman of GMO Europe in 2006. He returned to academic life in 2007, funding the Paul Woolley Centre for the Study of Capital Market Dysfunctionality at the London School of Economics. He is Chairman of the Advisory Board for the Centre and a full-time member of the research team. Similar centres have been set up at the University of Toulouse and at UTS in Sydney. He is an Honorary Professor of the University of York, Senior Fellow at LSE and an Adjunct Professor at UTS.

Charles Goodhart, CBE, FBA is a member of the Financial Markets Group at the London School of Economics, having previously, 1987-2005, been its Deputy Director. Until his retirement in 2002, he had been the Norman Sosnow Professor of Banking and Finance at LSE since 1985. Before then, he had worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. In 1997 he was appointed one of the outside independent members of the Bank of England's new Monetary Policy Committee until May 2000. Earlier he had taught at Cambridge and LSE. Besides numerous articles, he has written a couple of books on monetary history; a graduate monetary textbook, Money, Information and Uncertainty (2nd Ed. 1989); two collections of papers on monetary policy, Monetary Theory and Practice (1984) and The Central Bank and The Financial System (1995); and a number of books and articles on Financial Stability, on which subject he was Adviser to the Governor of the Bank of England, 2002-2004, and numerous other studies relating to financial markets and to monetary policy and history. In his spare time he is a sheep farmer (loss-making).