

The Future of Finance

Issues in re-shaping the sector's landscape



Written by:

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on behalf of a group of academic and industry leaders

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Introduction

The following briefing document summarises the outputs of the collaboration between co-hosts from major banks, consultancies, the World Economic Forum and academia, under the auspices and with the support of the Advanced Institute of Management (AIM) Research and London Business School. Building on recent AIM-sponsored research at London Business School, and bridging the worlds of academia and industry, we put together a working group to help shape the current debate around the future of the financial services industry and financial system.

The group we have assembled is unique, as it spans diverse backgrounds with regard to the industry – practitioners at the sharp end in the various subsectors of the financial system, academics and members of professional services firms. Normally, such a varied background leads to disconnect, divergent agendas and vocabularies. Our experiences here, however, have been to the contrary – we speak the same language and are united in our care for the financial system as a whole.

We are aware that surfacing those themes will not be in the interest of the many stakeholders, including parts of the financial services industry, whether regulated or shadow, that prefer the status quo. It will therefore be very difficult to surface them in an attributed fashion.

Whatever measure or suggestions are proposed as a result of our conversations, must therefore, as they should anyway, stand on their own merits, without the weight of authorial reputation behind them.

Our intention is, eventually, to draft position papers around a number of themes, and feed them into the ongoing debate on the financial system at the national and international level. The debate in the UK, following the recent publication of the interim report of the Independent Commission on Banking (and the ensuing legislation that may follow) is an opportunity to revisit some key topics. And while the momentum for an effective global financial redesign appears to falter disconcertingly, we still hope that these thoughts may help inform future discussions and sessions in Davos, the G20 (and B20) process, or other appropriate channels.

This brief note summarises our discussions to date, identifying some of the key themes involved. These also represent inconvenient truths – topics that are, we believe, still unresolved or misunderstood after the crisis.

We hope that the views of our working group will help further the debate.

“...we put together a working group to help shape the current debate around the future of the financial services industry and financial system.”

1 Compensation in financial services

Two years after the financial crisis, compensation in financial services (FS) still features prominently on the agenda of policymakers and the public at large. From this alone, it should be clear that residual issues exist in the area – or at least there is a lack of awareness about changes that have been made to the system.

All stakeholders want to see a constructive resolution of compensation issues – policymakers, regulators, society and even the industry itself. Yet they find it hard to agree on how to move forward in the most constructive way.

In many areas of financial services, compensation is no more of an issue than elsewhere. The average branch employees in a retail bank, for example, do not earn multi-million bonuses. Instead, the pay levels for such employees are reasonably well aligned with national average wages. Nor do such employees contribute in a significant way to systemic risk.

The issue of compensation is concentrated in the area of systemically relevant financial institutions, in particular wholesale banking, or firms that behaviourally mimic such institutions. Within those institutions, there is again a wide dispersion of roles – clearly, the reception staff or IT helpdesk do not contribute to systemic risk and are paid broadly in line with national wage distributions.

It is the relatively small population of risk takers or producers in systemically relevant firms where compensation is an outlier to anyone looking at national averages. To put this into perspective, of the 1.2m financial services employees in the UK, some 3,000 are estimated to earn in excess of £1m per annum¹ (and by extrapolation probably some 10,000 to 20,000 staff in excess of £500,000).

Some challenges

There are three main challenges levelled at historic compensation practices: the mechanisms of awarding compensation encourage inappropriate risk taking – particularly as they reward short-term gains, but do not penalise long-term losses; the absolute levels of compensation are too high, when compared to other jobs with similar levels of qualification or the contribution of financial services to society; related to the previous point, employees are seen to hold the industry and shareholders to ransom – pointing towards an inefficient market for talent.

It is also helpful to consider the different employee populations in the industry, with different risk and pay profiles:

Market makers (trading and sales): their role is to help firms with day-to-day risk management and give access to markets. In doing so, market traders have to build books of inventory to anticipate client demand, and in the process can build up significant systemic risk – if, for example, one bank ends up facilitating most of the market in a given product. Pay can be very high, particularly when the profits from longer-term strategies are accounted for upfront. As such, they can be subject to inappropriate risk taking.

Advisory bankers (M&A and origination): their role is to help firms merge or raise capital, and those roles contain limited systemic riskiness, *per se*. Pay levels can be very high, due to the way flagship transactions are priced.

Control staff: their role is to oversee the producers (that normally fall into the first two categories). Perversely, if pay here is too low compared to the producers, there is danger of the in-firm equivalent of regulatory capture. Control staff will try to build favourable relationships with producers, so they can ultimately transition into their area and share in the upside.

Finally, it is wrong to assume that everything around compensation can be set right through either extreme of intrusive regulation or free markets. Compensation is at the core of incentive systems that are ultimately designed to make people productive in a very complex industry. One problem in the current discussion is the obfuscation of the actual areas of problematic compensation with a debate on ‘free market’ versus ‘micro-regulated’ pay.

Recently, it has been argued that many problems in financial services are due to the emergence of an ultimately unsustainable industry architecture, where the division of labour and the business models associated with it led to a collective deterioration of underwriting, amplified by compensation practices.² Self-regulated pay structures exacerbated the problem. Whether or not that is the case, if history is to be a guide, we should allow that potentially problematic structures may emerge out of free competition, rather than assuming that they will be self-correcting. Thus, the role of industry-wide standards, or regulatory requirements for compensation, should not be considered problematic or not justifiable *ex ante*.

Furthermore, we are keenly aware that motivations which drive behaviours are not reducible to just direct monetary incentives in a performance contract; broader issues of career progression within and between institutions must be taken into account, and we need to consider the role of the non-regulated financial services sector. Also, individuals are not, as assumed in textbook theory, purely rational agents; biases, social comparison, and other aspects of behavioural science need to be taken into account as we look both at the causes of the problems, and at prescriptions that are potentially robust and sustainable.

Mechanisms that encourage inappropriate risk taking

This has been the focus of most of the regulatory effort following the recent crisis, and many steps have been taken here both by the G20, regulators and individual firms. The main thrust has been to defer larger parts of compensation for a longer period, including some claw-back clauses based on individual and firm performance.

This is certainly a step in the right direction – but some issues remain open. It should not be forgotten that in the case of Bear Stearns and Lehman Brothers, for example, large and broad-based employee shareholdings and a code of not selling the firm's stock (in effect amounting to very long deferral periods), did not prevent catastrophic failure. Simplistic proposals to pay large portions of variable compensation in deferred stock will not *per se* improve risk taking or stability at a systemic and institutional level.

Private gains, public losses: In the framework of public ownership and limited liability, it is hard to construct compensation mechanisms that fully reflect a situation where the upside accrues to private sector players, but the downside is ultimately borne by society. Private partnership would address some of the issue and has been suggested as a potential solution, but realistically would still, for good reasons, operate under limited liability and thus not solve the problem.

Wise after the event: It is hard to measure risk accurately, and therefore define risk taking *ex ante*. The large exposures to residential mortgages in the run-up to the latest crisis were deemed essentially risk-free at the time. Other than through claw-backs, it is impossible to address this issue – and even then, recourse will not be sufficient to drive behaviour.

Accounting devices: There have been historical instances where shrewd accounting allowed producers to capture most of the anticipated payout of a product upfront, without proper provisioning for potential downsides.

Staff were then paid a commission on the anticipated total lifetime profits, rather than just the cash flows accrued in a particular year. This issue was particularly rife in complex structured products. Both the significant shrinking of this product class, and increased regulatory pressure, have made this point less relevant today – though it should remain on the agenda, particularly where divergent accounting standards allow for arbitrage. Still, it should be recognised that some of the incentive problems are brought about by inappropriate accounting for profits. A more thorough engagement with accounting principles and practices seems called for and this issue has not been fully debated.

It is not only about the money: Executives may trade off monetary incentives based on stock, with other forms of gratification. Dick Fuld could be a case in point: Lehman's collapse cost him, personally, over \$900m; yet potential losses of this size do not appear to have been enough to have him challenge his own assumptions. Perhaps this was related to the fact that marginal utility of money may be decreasing at higher pay levels; or that other psychological mechanisms were in play. As we consider the disciplining role of incentives, a behavioural analysis may be of more help than advanced contracting theory.

Get rich quick: The salary progression, and perception of wholesale banking in particular, creates a get rich quick mentality that encourages risk taking at junior and middle levels of seniority. After all, if university graduates can start on \$50-75k in their first year and progress to \$1m within seven to ten years, why would they not try to play the casino? Especially as the downside may just be getting fired and starting a mainstream career in their early thirties like everybody else.

With a mindset like this spread across institutions, top-down risk management in particular becomes a challenge. Of the issues mentioned so far, this is probably the most overlooked, and yet ultimately the most tractable – though not at the level of individual firms. It is an industry issue, and has been for some while.³

Both the aggregate quantum of compensation (average pay times number of staff) and turnover rates (average tenure is often less than five years, leading to a 'not during my tenure here' mindset) at the upper-middle levels of seniority, such as directors or senior vice presidents, make this the most systemically relevant population of employees.

Adverse selection – the disproportionately greater career progression of those who succeeded by taking the ‘it’s a lottery’ view and winning – can exacerbate the problem, and send the wrong message. However, it should be noted that graduates have been entering firms already equipped with a ‘casino mindset’ and outsized expectations on career progression and pay. This suggests it would be unfair to put the blame solely on the industry and its culture or incentive mechanisms – factors in education, reported industry image, or societal biases, seem to have at least supporting influence. This observation holds across nationalities, which suggests a global development at play, either linked to education hubs or broader economic trends.

“...a behavioural analysis may be of more help than advanced contracting theory.”

Aspects of the last issue could be addressed by way of an agreed mechanism to limit year-on-year pay increases for junior and mid-level staff, thereby returning to more of an apprenticeship structure. Given that people make social comparisons on a relative basis, rather than absolute quantum, this might not be disastrous for the industry as long as it is uniformly and globally enforced, by way of a G20 or Financial Stability Board mandate – though there would be significant challenges around creating two populations with different tracks inside existing institutions. This point also links with the existence of a large shadow-finance system, such as the hedge funds, for example, which despite currently not being systemic in general, still sets compensation benchmarks for the regulated sector.

Absolute quantum of compensation

While bankers’ compensation has been significantly ahead of average national wages for quite some time, profitability in the industry had not suffered from this trend until recently.⁴ The current situation can be attributed to several factors, of which only few have an imminently tractable solution.

Some argue that the industry creates limited value, and mostly engages in self-referential activity.⁵ Financial services are an intermediate input. Be that as it may, it should be pointed out that the issue of rent extraction is very complex, is still in its infancy analytically, and at least warrants further study.

Caution must be used when we consider the role of financial services firms and their appropriate size. For instance, an often-heard fallacy, comparing the size of the UK banking sector with UK GDP (or share of profits of UK-based banks with other UK firms), ignores the fact that capital markets are a global phenomenon and their intermediation can create value disproportionate to the economy in the location of the intermediary. Banks could be viewed as similar to exporting firms in this regard. London, in particular, has long benefitted from this, which suggests the proper comparison for its profits and market capitalisation is not UK GDP, but European or even global GDP.

More constructively, there are instances where pricing structures are indeed skewed towards creating large profits for banks. Mergers and acquisitions and corporate advisory are examples where even a small percentage on a large corporate transaction can produce fees in excess of \$10m for just a few bankers. For this reason, many thriving boutiques exist in this area.

The issue lies in pricing off of the transaction value rather than the ultimate value created, which is much harder to measure. This is exacerbated by the fact that when it comes to such transformational deals, clients naturally seek the best advice and are less price sensitive than usual. To change this will require a complete overhaul of the broader economy’s management paradigms and governance structures – something that is unlikely to happen in the near term.⁶

To this, might be added the governance issues related to M&A activity overall, and those commissioning the deal and the advice, especially given M&A’s inability, on average, to yield long-term shareholder value.

Of course, profit levels could be reduced by way of taxation or fee caps – however, this would amount to significant intervention into the markets, which we would not see as justified given the limited systemic impact of corporate advisory. Banking, incidentally, is not unique in this – management consultancy in many instances prices off intangibles or large binary future outcomes. This relies heavily on brand value and customers’ desire to get the best advice, and therefore commands very high fee levels.

Another mechanism by which the industry generated high shareholder returns despite high staff payouts was through leverage – which ultimately had significant systemic impact. This is likely to be rectified within the framework of Basel III, and should exert corresponding pressures on staff payouts as firms continue to protect return on equity.

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It is ultimately the responsibility of boards to ensure that shareholders get the right prioritisation compared to staff or management – and we hope that they step up to this responsibility going forward.

Shareholders have not played a strong role in driving firms’ compensation in the past, and this is an area where they could play more of a corrective role in the future. To do so, they will have to overcome agency problems of their own, as many institutional shareholders manage other people’s money, which is slightly beyond the scope of this briefing. Still, it is worth probing the link between pay issues and governance of banks further

This last point leads to the observation that even if the management in banks, which are publically traded, has the view that reform is needed in terms of compensation practices, they are unlikely to be able to act as forcefully as they would want. The concern is that talent could move to a competing institution. And even though individually managers might know that such a short-term dip comes with long-term benefits, analyst pressures for short-term performance may lead them to accept practices which are not viable over the long-term. This is linked to the issue of excessive arbitrage by star talent; but also to the role of analysts and institutional investors on banks and their behaviour, which has not been fully considered. In fact the emerging academic evidence on analysts is quite sobering: empirical studies suggest analysts are poor judges of firm performance, which therefore questions the textbook model of corporate governance. (More attention should be paid to the potentially destabilising role of analysts).

The fact that investors, in banks and in the products originated by banks, have increasingly changed their own compensation practices and investment philosophy, effectively turning long-term capital to short-term return seekers, has substantially heightened the problem.

Finally, one way of controlling the pressures from short-term investors, could be to change the compensation basis in banks or other financial services. There are a number of potentially positive side-effects; and arguably some of these incentives might work for regulators, too.

Rather than relying primarily in stock options, or contingent convertibles (cocos) or similar, compensation might also be at least partly issued in subordinated debt. This would limit the incentive to engage in risky behaviour that would have stock price upside, at least until the options are exercised, and would also ensure that there is an alignment with the desire to safeguard banks’ reliability. A debt mentality would be vastly different from an equity mentality, even more so if one’s pension is related, with some debt-impairment performance metrics, to subordinated debt obligations.

Such a mechanism will carry significant administrative burden if deployed beyond small populations at the very top, and loses some of the desirable features of equity-based compensation – but it warrants further consideration and study.

Excessive arbitrage by ‘star talent’

While the absolute quantum of bankers’ compensation draws vociferous response today, there are other areas of society where even higher amounts are involved with little outcry – namely sports and entertainment.⁷ This, in our mind, is down to two differences. Firstly, it is easier for a layperson to understand what a footballer or singer does, and why this constitutes unique talent. Secondly, the benchmark for talent is more transparent in those areas – a footballer will usually play many matches and their talent be widely recognised among the football community before being offered a Premier League contract.⁸

The talent market in financial services may well be too opaque. Two skewed incentives are worth mentioning.

Firstly, employees who see declining performance on their trading books after several years of good runs, will have rational incentives to find another employer before this performance crystallises in the next bonus round. The new employer will see only the historic track record, and therefore overpay, usually as a guaranteed package, compared to forward-looking performance.

Secondly, due to the ultra-competitive nature of wholesale finance, even in cases where an employee is underperforming, the current employer benefits from supporting their move to a competitor with a good reference, thereby inflating the competitor's cost base. Combining those two incentives with the highly specialist nature of wholesale financial services makes for a very opaque talent market.

We propose the creation of a 'performance repository' for mid-level and senior banking staff at a neutral institution, such as the regulator, for example. This repository could be tapped by any hiring firm to assess the actual performance of a candidate, and would therefore reduce staff's ability to arbitrage firms against each other and through collective action increase pay levels.

Given that the repository should include not only HR rating data, but ideally also information on productivity, it must be held at a trusted institution, and the national regulator seems the most appropriate choice. Even so, care must be taken not to share commercial information among competitors – but this could be achieved by devising a score card mechanism or similar. While we do appreciate that the idea might be met with some concern, not least in terms of the veracity of information contained, some repository of information (perhaps of 'red flags') could be of use.⁹

As a related point, in many cases in the past, star players have been able to overplay their own productivity and underplay the contribution of their firm's resources – inflating pay by linking it to revenue, rather than an appropriately costed profit. This has been a particular issue in universal banks, where both the intangible franchise value and the tangible balance sheet or infrastructure have not been attributed to individual units. Basel III will change some of this, but probably still leave a shortfall, particularly in the attribution of brand and infrastructure. More thinking on this point is required, as it offers a unique opportunity to rein in 'casino risk' in integrated banks – potentially more so than outright separation or downsizing.

Between regulators and the industry, who at board level understand the issue, further work on this issue would be very constructive, with the aspiration to create an approved transfer price methodology, which would provide some broad agreement in terms of a platform, even though each bank may elect to adopt its own methodology.

An argument could even be made for disclosure to the regulator of the internal transfer pricing method, so as to assuage any potential concern of trading activities or even investment banking activities free-riding on the, implicitly or explicitly state-guaranteed, depositor-funded part of the balance-sheet.

As a closing thought, the funding advantage of integrated institutions currently and justifiably attracts a lot of attention and the free-riding aspects are emphasised. Yet we acknowledge that there can also be alternative views – for example, at some integrated banks returns from the investment bank helped the retail operations through a downturn – through the UK property crisis in the early 1990s, for example.

Obviously, some of the funding advantages of the wholesale arm, those related to derivatives, for example, can also be of benefit to clients in the form of cheaper hedging (for a corporate) or yield enhancement (for a pension fund investor), assuming they are passed on. As so often, the picture is more complex than simplistic rhetoric suggests.

Finally, we want to draw attention to the shadow financial services sector, such as hedge funds and private equity – which, despite having had very limited contribution to the recent financial crisis, nevertheless tend to anecdotally skew pay expectations in the fully regulated industry. Competition for talent between those two sides of financial services often happens in an individually rational yet collectively destructive fashion. Yet some of the practices in shadow financial services, such as deferred compensation in private equity firms, has been ahead of the curve for many years.

In our mind, further exchanges between the fully regulated and less regulated sectors of financial services on compensation would be very helpful to reduce unhelpful arbitrage patterns that might ultimately destabilise the whole industry. The World Economic Forum in Davos, or similar platforms, might be the appropriate mechanisms for those conversations, which by their very nature should be informal initially.

To conclude, arbitrage is not necessarily a bad thing – be it on talent, taxation or regulation – even though this might sometimes be hard to digest morally. Arbitrage, if it happens at a small scale and is well monitored, will create better differentiated business models and ultimately a more stable system. Only when arbitrage adopts an unhealthy scale, and leads to crowded strategies, does it become a systemic threat. In this spirit, we wonder whether it would be sensible to allow and accept arbitrage with effort put into monitoring it, only intervening with regulation when it breaches a certain scale. This, in our view, might be more effective and pragmatic than assuming arbitrage, which is a fundamentally human interest, can be regulated away completely and forever, turning therefore a blind eye to the potential cause of the next crisis.

2 Time horizon mismatches

The issue: the perils of short-termism

Decision makers, whether politicians or CEOs of quoted companies, often adopt a short-term outlook and as a result exhibit behaviours that are to the detriment of systemic stability and, potentially, long-term prosperity.

These behaviours are exacerbated by so-called market forces, the actions of equity analysts, for example, that cater for a short-term, often quarterly, outlook and in this way make even fundamentally long-term investors, such as pension funds, take a more short-term view than they might otherwise. Changes of compensation and associated agency problems in investor organisations (another neglected theme) may have also been a major driver of the herd behaviour and risk contagion of the recent financial crisis.

The argument

There is an ever-increasing short-term orientation of decision makers. This is exacerbated by a constant focus, especially in the media, on recent information. So, for example, there is an emphasis on quick, identifiable actions for politicians and policymakers, and on measurable indicators of success for private, public, and regulatory actions. Add to this the need to focus on short-term performance metrics, and these have undermined the efforts to sustain the long-term stability of the system.

This leads to a fundamental challenge: balancing the need to maintain accurate performance management, and with that the ability to identify potential problems before they do too much damage, and acting in ways that are for the benefit of the long term.

One potential solution would be to decouple the metrics from such a strong short term focus. So, for example, looking at Earnings Per Share only over longer time horizons, with more operational metrics in the short run. A problem with this approach, however, is that the link between operational metrics and financial long-term performance is non-trivial and little good research exists which examines the relationship between the two.

More troubling still, research on performance management has shown that operational measures can easily become 'corrupted' as those measured adapt their behaviour in potentially perverse ways. And simple solutions that have been suggested, such as rewarding regulators with pensions linked to subordinated bank debt, may have unintended adverse consequences, such as sustaining zombie banks. The question of how, within the current institutional setup, we can design incentives that do not exacerbate the time horizon mismatch problem, remains to be properly researched.

Changes in the way that organisations with long-term funds reward and incentivise the performance of their asset managers is another issue that has not been fully considered. Our sense is that increasing short-termism is appearing even in those institutions with presumably long-term interests, and this can have severe destabilising effects. Also, changes in governance throughout the sector, and the almost complete dominance of publically listed companies (or companies managed as if they were publically listed, as contrasted to partnerships for example), has further exacerbated this trend.

As we consider both research into and solutions to this problem, it is important to note that psychological tendencies and biases also play a role. A substantial amount of evidence has emerged on the nature of these biases, including discounting of the future, but also the strong disciplining impact of framing, anchoring, and saliency heuristics. Likewise, our understanding of human action suggests that comparative assessments, as opposed to ordinal measures of outcome, for example the magnitude of the NPV of bonuses as an absolute level, drive behaviour and satisfaction.

Yet current research in incentives, still steeped in traditional micro-economics, routinely ignores these dimensions. We would suggest that a behaviourally more informed approach be considered in the context of financial services, so we move beyond simplistic monetary claw-back mechanisms as the solution to all ills.¹⁰

As a result of the observations above, there should be scope for cross-functional work, between those who operate to long-term horizons, such as family offices, sovereign wealth, NGOs, and some flavours of private equity, for example, and, on the other hand, public company CEOs, politicians – supported by appropriately calibrated academic research.

Our view is that, even in the corporate world, there is substantial discomfort with the short-term orientation, although it tends to be seen as a constraint that needs to be tackled tactically, and not a fundamental issue that can be effectively redressed.

The group may consider directions for actionable academic research that might help lead to a more robust set of mechanisms. The World Economic Forum or other international bodies may also be well-placed to consider if there would be any low-hanging fruits to be had by bringing together those with different perspectives.

“There is an ever-increasing short-term orientation of decision makers. This is exacerbated by a constant focus, especially in the media, on recent information.”

It is important to note that some of the recent financial innovation may have made the mismatch problem worse, leading to inappropriate decisions. We have, for example, created new ways of organising loan production that include a sharper short-term focus on long-term funding decisions. Indeed, one of the most important changes in securitisation was to recognise the revenues upfront, but consider the risk much later, once the relevant parties – brokers, originators, structurers – have already taken their money.

Innovation which systemically accentuates the ‘horizon mismatch’ problem (within or between institutions) may need to be re-evaluated. The issue of managing the short and long term tensions, and the incentives or even just the accountability associated with these, needs to be explicitly addressed. It is crucial in financial services, and we would suggest explicitly considering what can be done to alleviate the issue.

Ratings agencies, governance, and time horizon mismatches

A particularly acute manifestation of the time horizon mismatch problem comes in the guise of ratings agencies. Despite research pointing to the critical role of ratings agencies in bringing about the crisis¹¹, and the concern with having publically listed, profit-maximising firms undertaking the ratings (as opposed to, for example, a partnership with a greater attention to long-term value, as opposed to quarterly results), nothing has happened in this regard. For rating agency CEOs, tasked with increasing the share price, the shadow of a potential loss of reputation only looms large at the wake of a crisis. So the current (potentially excessive) caution will probably give way to increasingly optimistic views, and downright participation to a deterioration of ratings qualities in the next book. Neither the business model, nor the governance structures of ratings agencies have changed, so we have failed to engage in an important reform for the long-term stability of the sector.

Ironically, the lack of serious reform of the ratings agencies model is due to the time horizon mismatch between policymakers (and politicians) and the viability of the financial system. Indeed, recent EU efforts to reform the ratings agency regimes seem to be motivated at least partly from the potentially detrimental effect the ratings agencies have to member-state borrowing conditions, and to the associated, immediate, political pressures governments face.

A serious discussion on the nodal role of ratings agencies is overdue, as Basel III regulations means that banks will have to shrink their balance sheets, and as such we will need to see some return of securitisation, or other capital-market mediated lending, to fund ongoing requirements. This means that ratings will become ever more important; and while the current risk-aversion of ratings agencies might appear to have partly solved the problem, the medium term instability inherent in their business model, and their governance structures, have yet to be addressed.

Time horizon mismatches appear to be getting in the way of a serious discussion, and the global dimension of the sector is further complicating a viable solution. Sadly, the seeds of the next round of problems remain, and our refusal to address such longer-term issues may backfire sooner than anyone would hope.

3 Segregating the activities of banks

The issue: banking break up – for and against

A lot of overly simplistic calls are made to break up banks into their wholesale and retail component parts. While the industry is resisting it, for the most part, a rational debate is required to determine what such break-ups might or might not achieve. This is particularly pertinent in light of the UK's Independent Commission on Banking and its forthcoming recommendation.

While the comments described here were made before the publication of the Interim Report of the Independent Commission on Banking, we feel they still are relevant.

The issues should be considered both in the context of a discussion of the business model alone, mapping costs and benefits; and then, separately, adding in factors such as the global competitive dynamics, led by the inescapable inability to coordinate regulators, and a possible global race to the regulatory bottom that might emerge.

The argument

To date debate around the separation of banking functions has often been simplistic, with the break up of the banks pitched either as a systemic panacea, or as catastrophic move likely to drive many banks out of the City of London, accompanied by the use of emotive terms such as casino banking and systemic meltdown.

The benefits of segregating wholesale and retail banking are not as immediately apparent, as they might have been at the time of the Glass Steagall (1933) legislation in the US, which separated banking according to type of activity. These measures were taken at a time when there were supernormal profits on Wall Street and several banking crises.

“It is worth noting that small does not necessarily mean systemically stable.”

Banking separation has two implied benefits: a reduction in size, making an institution less systemic; a change in funding model and the removal of internal subsidies, affecting the scope of the firm. As scale and scope are two distinct issues (even if they co-exist in large, global bulge-bracket banks), we treat each separately.

Size

It is worth noting, however, that small does not necessarily mean systemically stable. Having many small banks with a similar business model, as with the US Savings and Loan crisis, can render the system as vulnerable as with smaller numbers of very large institutions, if not more so. If numerous small correlated institutions default a state bailout will still be necessary.

While the recent discussions of Systemically Important Financial Institutions (SIFIs) are improving in this regard, the role of size is probably still overly emphasised.

This suggests that there is an urgent need to consider alternative measures of importance – or, perhaps better, of systemic risk.

There are benefits to size in banking, primarily in wholesale banking, many driven by expectations of multinational corporations in the real economy. Unless we rewind globalisation, or expect the real economy to revisit its financing model, those benefits will persist. The magnitude and nature of these benefits, however, need adequately researching and debating.

There are also dis-economies of scale, some firms arguably having grown too complex to manage. Consequently, there might be an optimal size from an efficiency perspective, although it appears difficult to disentangle scale from scope in some of these discussions.

Funding model

The funding model and scope of banking activities offer a clearer story – universal banks gain a legitimate advantage, at least from the perspective of portfolio theory, by having a more diversified balance sheet which allows them to fund their wholesale operations more cheaply.

This is not necessarily putting depositor money into the casino – as some commentators have described it. After all a pension fund investing in equities is not accused of putting pensioners' funds into a casino.

However, regulators (and society) might take a view that this cross-subsidy inherent to universal banking distorts competition, and that the quest of returns leads the investment banking side to gamble with the balance sheet offered by depositors. Although this also raises other questions: what would the systemic role of non-depository investment banks be.

Any change in scope should be considered in a clear cost-benefit framework, considering both the expected net benefits and the potential risks involved – for a number of stakeholders.

Looking at some of the costs of separation, the consequence of removing the subsidy, whether by way of outright split or internal ring-fence, would be higher cost of wholesale banking, some of which might filter into the real economy and increase the cost of capital and hedging. An argument can be made that the artificially cheap current set-up incentivises more active risk management in the real economy, which is systemically stabilising. We feel that more empirical research on this issue would be useful.

Cost benefit analysis

Whatever the different views on the role of separation it is essential to consider the cost benefit analysis in terms of the financial system as a whole, painting different futures for it in dispassionate impartial fashion.

One of the potential components of the cost benefit analysis from society's perspective would be the possibility of better competition dynamics in the segregated markets. However, the extent to which these benefits are sufficient to tip the balance in favour of a break up, remain an issue for further research.

Also, arguments of a better production process as a result of separation the proposal to have payments run as a utility, and charged as much, for example, need to be critically evaluated. The experience of the electricity sector deregulation and segregation into utility and service provision, starting from the Thatcherite governments of the 1970s and extending to the recent European medley of de- and re-regulation, as well as the US energy debacle, may have interesting lessons to offer. Forced vertical dis-integration has not always lived up to its expectations. More debate is needed on both the benefit, and the cost or risk side, based on evidence of this and other sectors.

Another important issue to consider is what implications the regulation of the formal banking sector would have for the shadow banking sector. It is becoming increasingly important to consider whether and how to regulate those entities which form part of the financial services sector but that are not formally regulated, from captive automobile financing to hedge funds, private equity houses or other non-traditional participants.

Research on the relationship between the shadow system and the regulated sector needs to be considered, especially as we contemplate the implications of changing scope and the nature of activities in banks. Such research needs to take into account the risks, as well as the potential loss of credit provision (trade financing being a simple illustration. Who would do this and how?).

A further consequence of banking separation is that the only credible mechanism for wholesale banks to manage their balance sheet commitments at scale, and in a reasonable timeframe (<3 years), is securitisation. So the proponents of separation need to have a view on how to restart securitisation in the short run – a link missing in today's public debate.

As a result, there is more to the issue of SIFIs than issues of size or purely scope (in terms of deposit-taking and wholesale activities). Research, still embryonic, into interconnectedness, considering the nature of the *business model viability*, whether the business model is small or large scale, may be worthwhile.

Our working group may conduct further discussions about the merits and shortcomings of business models, or, to use recent research done at London Business School, the 'industry architecture' that emerges, as a means to check the systemic viability of the sector.¹²

Discussions of business models, how they operate and make money, and of the alternate benefits or shortcomings of different rules of the game, resulting from different architectures and setups, need to be made publically. There is still a gap in the understanding of how different types of financial institutions both make money and add value to the economy.

A discussion of alternate futures for the financial services sector could therefore be a value-adding activity that applied research institutes or academic institutions might usefully undertake. It would also be useful to engage in such discussions not only in settings such as the World Economic Forum, but also through regulatory and supervisory agencies, that could usefully collaborate with academics and industry participants in creating scenarios of the evolution of the sector – and its stability.

The experience we had in our dinner series suggests that there is substantial scope for further engagement between different participants of the sector, and initiatives such as the Independent Banking Commission hearings are surely helpful steps in this direction that can be further expanded upon.

Ringfencing to the rescue? The devil in the details

A topic which emerged after our discussions relates to ringfencing the activities of banks in the UK, as a result of the Interim Report of the Independent Commission on Banking.¹³ The extent to which this solution will present an improvement on stability of the system will critically depend on the details of its implementation. The principle alone cannot guarantee an improvement of financial stability. Furthermore, ringfencing raises some interesting governance issues. Would the board-members of some banking entities also have a fiduciary duty to the State, which provides the (implicit or explicit) guarantee to the ring-fenced entity? How should the duties of different boards in a banking group co-exist, and how would they relate to the global dimension of competition?

“Research on the relationship between the shadow system and the regulated sector needs to be considered, especially as we contemplate the implications of changing scope and the nature of activities in banks.”

4 The scope of regulation and incentives for self-correction

The issue: the nature of markets

Markets have been shown to sustain and even support practices and valuations that are not viable. An 'equilibrium' is a state from which actors do not want to deviate, and has no normative connotations, nor any positive implications. The idea that 'markets' (in their guise of non-regulated locus of economic activity) are self-correcting ignores a good deal of economic and business history, especially in financial services.¹⁴

It is for this reason that markets are augmented by regulation. Yet regulation often leads to more arbitrage and therefore instability. This is particularly true where regulation goes by form rather than function, as was the case for AIG, for example. Shadow finance systems are often an outcome of such regulation.

Yet regulation is paradoxically the current single answer of choice to all concerns about market instability. The question, therefore, remains whether there are incentives or mechanisms inherent in markets that drive for self-correction, and therefore can augment regulation if appropriately emphasised; or alternatively if the idea of a self-correcting mechanism can lull us into complacency, given its limited empirical basis. This opens up the discussion of the nature and scope of regulation, both at the national and the global level. While some changes have occurred in the aftermath of the financial services crisis, much remains to be done, as market participants would privately acknowledge.

The argument

At an abstract level, markets react to incentives. Firm-level incentives are either endogenously created by markets themselves, mostly through supply and demand interactions, or set exogenously through fiscal and monetary policy parameters and regulation. It is often thought that markets self-correct, in the sense that in reaction to shocks they determine a new and presumably socially desirable equilibrium. However, we have learned that market equilibriums are not necessarily stable, nor do they have to be socially desirable. At the same time, we know that markets can get stuck in an unstable equilibrium whose correction can inflict high adjustment costs.

It is in the nature of financial markets that failures of single actors can be highly contagious. They may impose liquidity constraints on otherwise sound and solvent competitors, which tend to undermine the stability of the whole system. This is one of the reasons, in addition to consumer protection, why markets are regulated. Prudential regulation is supposed to prevent systemic failure.

Until now, the chosen approach to regulation was predominantly microprudential. This was based on the belief that if supervisors can ascertain the health of each single participant, the system as a whole will be sound and stable. However, this approach fails to acknowledge that supervisors in most cases do not have the supposed superior knowledge and insight that would allow them to spot the rotten apple that will eventually spoil the whole barrel, or in this case the financial system.

It also fails to recognise that systemic interactions can destabilise a financial system that at the outset looked healthy, but on closer inspection was built on shaky foundations, such as excessive leverage. This explains why seemingly stable and profitable markets can suddenly crash imposing high costs.

In hindsight, it is easy to see that the microprudential approach to regulation failed to spot unsustainable credit bubbles. For that reason, the call for more of the same – regulation – is bound to fail again. Hence the call for a shift in the regulatory focus, to better pay attention to systemic interactions that potentially could derail the whole market. In other words, we should think about complementing the microprudential approach with a macroprudential approach to supervision.

A macroprudential approach

Such a macroprudential approach to supervision would presumably be more mindful of macro-incentives impacting financial market participants, and it would be more mindful of the systemic interactions among market participants. This requires inter alia the careful monitoring of the environment financial markets are operating in, which will, at times, result in changes to the incentives set by policymakers ('leaning against the wind'). Since systemic failures cannot be ruled out entirely, macroprudential supervision should also endeavour to strengthen the resilience of market participants in order to mitigate the impact of systemic failure.

It is early days in the debate about macroprudential supervision. While the notion has been around for many years, it is only recently that the G20 has called on the FSB and other policymaker forums to come up with a framework for macroprudential supervision. The question is what kind of new incentives, or indeed unintended consequences, will be introduced by a shift in focus toward macroprudential supervision.

Currently, the debate seems to be heavily focused on how to capture and regulate SIFIs, which gives rise to a whole set of new problems, not the least problems associated with moral hazard. Another set of questions relates to the consequences of regulatory homogenisation, either to create a level playing field, (industry's desire) or to prevent regulatory arbitrage (the supervisor's view). The latter would tie in with the research agenda defined by last year's *Re-thinking Risk Management* project initiated under the auspices of the World Economic Forum.

Another related issue is that regulation should not only focus on the better management of the segments which remain regulated, but also on the nature of the overall industry architecture in financial services, including the shadow banking sector, as well as the way investors interface with intermediators. In this sense, macroprudential supervision should revisit critical components of the financial services system, such as ratings agencies; review the means by which capital providers interact; consider the stability of derivative markets, and transactions that are allowed or not, as the case might be; and take a view of the stability of the overall system.

While such an architectural view might not be easy to take, we think it may be crucial for the future viability of the system. Establishing the appropriate institutional framework to undertake it, in a cross-national level, is another practical challenge, especially given the multitude of industry participants who might be privately incentivised, in the short-term, to work against it (let alone political considerations and geo-political squabbles).

Moving forward

In order to understand the nature of the sector and how regulation can work, even in its macroprudential guise, we also need to look at the specific institutional detail of those involved. This involves two components. First, understanding how different types of organisations in a sector make money, in other words understanding their business models, and how these add up.

And second, how, within these business models, success is rewarded. A second point relates to the actual layout – the architecture – of a sector, and how this shapes feedback, and thus behaviour.¹⁵

Pension funds and other long-term investors should, in principle, be able to exert some stabilising influence on markets, though the mechanisms by which they do this probably warrant further research. Interestingly, the way these are run, which also relates to the compensation policies for those who manage such pools of investments, might exacerbate the crisis.

In addition to investors, mainstreet corporates have been unwitting participants in the financial services ecosystem – most notably, treasury executives investing in risky CDO's during the crisis. It is important to consider how the nature of financial activities within the corporate sector may work to either dampen or exacerbate a potential risk – whether in terms of demand for capital or supply of cash invested in instruments devised by the financial services industry. Their ability to dampen or exacerbate, and perhaps even cause problems, should be considered.

While there is, then, abundant evidence that the crisis, given the current setup, faced mechanisms that exacerbated the situation, rather than dampened it, the question is why we would expect otherwise.

Over the last two decades the idea has emerged of 'a market' that would be self-regulating, and this was juxtaposed to a regulated system. However, this analytical contraption is a bit too sketchy to be realistic: Markets really are sectors; sectors have their own norms of competing; these norms cannot, except under very unusual circumstances, be effectively built bottom up. In other words, a realistic – as opposed to a stylised – depiction of markets helps us see why, when and how these markets are not self-regulating. Add in a good dose of agency problems and a sprinkle of behavioural assumptions, to reflect the world we live in, and the idea that sectors, and therefore markets, would regulate themselves becomes odd at best.¹⁶

As we consider regulation and its ability to shape behaviours, we must look critically at the record to date. We fear that the current inclination of politicians to seek to regulate behaviours is unlikely to have a favourable outcome. Regulators work best, and regulatees respond best, when the task is comparatively straightforward, such as regulating structures and activities that are clearly permitted or not. Issues of simplicity and the ability of regulators to shape outcomes should be explicitly considered. We consider that this is an area where substantial progress can be made.

“The idea that ‘markets’ (in their guise of non-regulated locus of economic activity) are self-correcting ignores a good deal of economic and business history, especially in financial services.”

Appendix

The Shadow Banking System

Over the last two years, the creation of the shadow banking system has been identified as a key driver of financial instability. The growth in unregulated derivatives in particular has seen substantial amount of scrutiny and call for reforms. Similarly, activities of hedge funds and private equity houses have increased their overlap with services offered by regulated financial institutions.

Yet while calls have intensified for greater regulation of such activities, action has been limited and not comprehensive. In the aftermath of Basel III, which will surely push banks to abandon some activities they used to undertake, and be controlled for, to other entities, the role of the shadow banking system requires closer scrutiny.

The working group has not spent much time considering this topic to date, hence the inclusion of our thoughts in this appendix, rather than the main body of the briefing. However, we would argue that we need to consider more explicitly what activities that pertain to banking are performed by different types of institutions, and what are the implications for either regulatory oversight, or indeed the stability of the financial system as a whole.

The risk still remains that the non-regulated part of the financial services industry might be the originator of the next financial crisis. Issues of scope, transmission, and systemic impact will need to be assessed, as should the incentives within this segment.

References (Endnotes)

- ¹ www.guardian.co.uk/business/2010/jul/29/fsa-toughen-city-pay-code-bonuses
- ² See, e.g., Jacobides, M. G. and Winter, S. G. (2010) "The Survival of the Reckless: How the US Mortgage Industry evolved towards disaster"; AEA Proceedings.
- ³ See, e.g., Augar, P., 'The Death of Gentlemanly Capitalism', Penguin, 2001.
- ⁴ For a thorough discussion of both the level of compensation in financial services in general, and the recent changes in terms of trends, see Philippon, T. and Reshef, A. (1996) "Wages and Human Capital in the U.S. Financial Industry: 1909-2006"; NBER Working Paper No. 14644. The authors also link potentially excessive payments to deregulation and profitability in the sector as well as substantial rent-seeking in a loose environment.
- ⁵ See e.g., Haldane 'The \$100bn question' (www.bankofengland.co.uk/publications/speeches/2010/speech433.pdf) or the FSA's Turner Review (www.fsa.gov.uk/pubs/other/turner_review.pdf).
- ⁶ See e.g., Augar, P., 'The Greed Merchants', Penguin, 2006.
- ⁷ It might be worth noting that in some popular US sports there is a salary cap, rhetoric about the free market notwithstanding.
- ⁸ The increase of disparity in compensation between average and top performers has been noted in a large part of the economy (see Frank, R. H. and Cook, P. J. (1995), *The Winner-take-all Society*). Such rising inequalities, in any sector, do not have easy remedies. Some suggest they ought not be regulated, while some are fiercely pro regulation.
- ⁹ We do appreciate that, normally, a fair deal of due diligence may happen when talent moves from firm to firm. Yet, mechanisms in place should facilitate the elimination of errors, or reduce the pressures to corrupt the system of inter-company career progression, and reduce the opportunities offered where diligence is not as effective as it should be.
- ¹⁰ For a provocative example of behaviourally informed policy interventions see Thaler, R. H. and Sunstein, C. R. (2008), *Nudge: Improving decisions about health, wealth and happiness*, Yale University Press.
- ¹¹ Jacobides, M. G. and Winter, S. G. (2010), *ibid*, discuss the role of ratings agencies as nodal in the changing architecture of the financial services sector, suggesting that the pressures to relax their risk assessment were too difficult to resist. This was corroborated by the US Senate Permanent Sub-committee Hearings on the role of Ratings Agencies in the Financial Crisis, in April 2010. Also see Skreta, V. and Veldkamp, L. (2009), *Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation*, NBER Working Paper No. 14761 for a model, and Goodhart, C. A. E. (2008), *How, if at all, should Credit Ratings Agencies (CRAs) be Regulated?* LSE FMG Special Paper 181 for a tempered view.
- ¹² See Jacobides, M. G. and Winter, S. G. (2010) "The Survival of the Reckless: How the US Mortgage Industry evolved towards disaster"; AEA Proceedings, and associated discussion in "The Future of Finance", 2010 Harvard Business Review blog.
- ¹³ Report available through <http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf>
- ¹⁴ See Reinhart, C. M. and Rogoff, K. (2010) *This Time Is Different: Eight Centuries of Financial Folly*, Oxford, Princeton University Press.
- ¹⁵ This view on the analysis of 'industry architectures' and the associated business models in the sector, noted earlier, could help augment current policy tools as we consider the future of the sector, beyond the sketch offered here. Building on that research, it would be advisable to sketch out the proposed solutions in terms of new regulations, map their impact on the industry architecture, and consider whether, in the context of all players (regulated or not) the system would become more shock-absorbent. Of course, this approach suggests that policymakers and regulators become better versed in understanding the institutional detail of the sector; and that we engage more with research looking at business structures and business models, as they shape financial services.
- ¹⁶ It would be interesting to get examples of self-stabilising systems from other areas, such as ecology, and see what can be applied to financial markets. Doing so would have good synergies with a potential project mapping the financial services industry architecture and its potential futures – with a key question being what would be the systemic, built-in dampers of instability.

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