in brief...
The future of finance

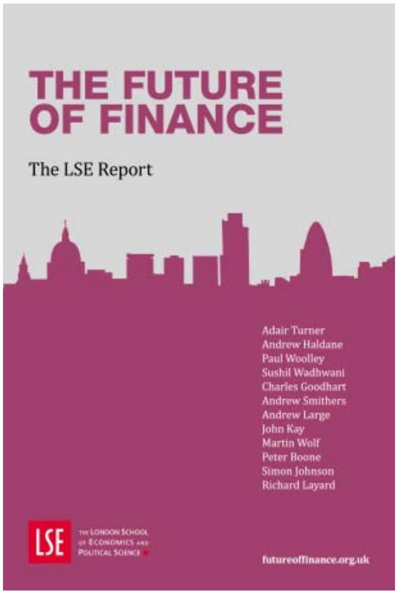
What is a financial system for? That is the starting point for the LSE's recent report on reform of the world's financial system, which brings together the work of leading academics, financiers, journalists and officials from the UK's Financial Services Authority, the Bank of England and the Treasury.

The financial crash of 2008-9 has been the most damaging economic event since the Great Depression, affecting the lives of hundreds of millions of people. The most immediate problem now is to prevent a repeat performance.

The central question is what the financial system is for? Standard texts list five main functions: channelling savings into real investment; transferring risk; maturity transformation (including smoothing of lifecycle consumption); effecting payments; and making markets. But looking at how financial companies make their money, it is extraordinarily difficult to see how closely this corresponds to the stated functions, and it is often difficult to explain why the rewards can be so high. Any explanation must also explain why the system is so prone to boom and bust.

The opening chapters of the LSE report (by Adair Turner, Andrew Haldane and Paul Woolley) deal with these fundamental issues: the ideal functions of the system; the way the system has actually operated; and the sources of boom and bust. To answer these questions, much of the abstract theory of finance has to be abandoned in favour of a more realistic model of how the different agents actually behave.

Central to this is opacity and asymmetric information, combined with short-term performance-related pay. For example, the asset price momentum that accompanies booms occurs because the owners of giant funds expect fund managers to shift into the fastest rising stocks. (They would do better to invest on a longer-term basis.)



The opacity of the system has increased enormously with the growth of derivatives. Did this contribute to high long-term growth? The issue remains open. On one side, people point to the high real growth during the period 1950-73 (an era of financial repression) and the real cost of the present downturn. On the other side, many studies, discussed in the report by Sushil Wadhwani, point to real benefits from financial deepening. But apart from his chapter, all other contributors invoke the need for a radically simplified and slimmer financial system.

There are four aims of such a reform. The first is to prevent the financial system destabilising the real economy, as it has in the recent past. The second (closely related) is to protect taxpayers against the possible cost of bailouts. The third is to reduce the share of real national income that accrues as income to the financial sector and its employees for reasons not related to the benefits it confers – thus absorbing into the sector talent that could be more usefully used elsewhere. And all of this has to be done in a way that works.

There are two main lines of approach. The first is regulation – higher capitalisation of all financial institutions, and levels of required capital that rise in a boom and fall

The financial system has become far more complicated than it needs to be to discharge its functions – and dangerously unstable into the bargain

What's needed is a radically simplified and slimmer financial system

in a slump. In the report, Charles Goodhart points to some of the difficulties involved in any such regulation; Andrew Smithers shows that asset price booms can be identified, at least sometimes; and Andrew Large discusses how such information could be used, if there were an independent committee specifically charged with 'macroprudential regulation'. (Sushil Wadhwani argues by contrast that financial booms should be mainly controlled via interest rates.)

The second main approach to a more stable system is institutional reform. John Kay argues strongly for the introduction of narrow banking. In such a system, only deposit-taking institutions could expect to be insured through the state, and they would not be allowed to build up a balance sheet of risky assets. This is a version of the so-called Volcker Rule.

Faced with these two possible lines of approach, Martin Wolf comes down in favour of strong regulation, linked perhaps to some institutional reform, aimed especially at greater competition. He argues that the state would in fact bail out any major financial institution threatened with bankruptcy, whether deposit-taking or not; it must therefore regulate all institutions.

Moreover managers must face totally different incentives and pay. In particular, Wolf suggests the managers should be liable to repay a substantial proportion of their pay if their institution requires state assistance or goes bankrupt within ten years of their getting that pay.

All these proposals would directly reduce the profitability of banks and the pay of bankers. Do they have a chance? In the final chapter of the report, Peter Boone and Simon Johnson document the huge influence that banks exert in the political sphere worldwide. They argue that only a worldwide system of regulation embodied in a global body, comparable to the World Trade Organization, could have a chance.

In this context, it is encouraging that the Working Party of the G20 Financial Stability Board, which will deliver proposals to the G20 Summit this November, is chaired by the author of the report's opening chapter, Adair Turner.

The Future of Finance: The LSE Report was published in September 2010 (ISBN: 978 0 85328 458 1, £14.99). To order a copy: call 0845 458 9910; email: mo@centralbooks.com; or visit http://www.futureoffinance.org.uk

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