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JOHN KAY is a visiting professor of the London School of Economics, and a Fellow of St John's College, Oxford. He is a director of several public companies and contributes a weekly column to the *Financial Times*. He chaired the UK government review of Equity Markets which reported in 2012, recommending substantial reforms. He is the author of many books, including *The Truth about Markets*, *The Long and the Short of It* and *Obliquity*.

OTHER PEOPLE'S MONEY

MASTERS OF THE UNIVERSE OR
SERVANTS OF THE PEOPLE?

John Kay

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The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own … Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

Adam Smith, *The Wealth of Nations*, 1776

When I speak of high finance as a harmful factor in recent years, I am speaking about a minority which includes the type of individual who speculates with other people's money – and you in Chicago know the kind I refer to.

Franklin D. Roosevelt, US presidential campaign address, Chicago, 14 October 1936

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PROLOGUE

The parable of the ox[1]

In 1906 the great statistician Francis Galton observed a competition to guess the weight of an ox at a country fair. Eight hundred people entered. Galton, being the kind of man he was, ran statistical tests on the numbers. He discovered that the average guess was extremely close to the weight of the ox. This story was told by James Surowiecki, in his entertaining book *The Wisdom of Crowds*.[2]

Not many people know the events that followed. A few years later, the scales seemed to become less and less reliable. Repairs would be expensive, but the fair organiser had a brilliant idea. Since attendees were so good at guessing the weight of an ox, it was unnecessary to repair the scales. The organiser would simply ask everyone to guess the weight, and take the average of their estimates.

A new problem emerged, however. Once weight-guessing competitions became the rage, some participants tried to cheat. They even tried to get privileged information from the farmer who had bred the ox. But there was fear that, if some people had an edge, others would be reluctant to enter the weight-guessing competition. With few entrants, you could not rely on the wisdom of crowds. The process of weight discovery would be damaged.

So strict regulatory rules were introduced. The farmer was asked to prepare three-monthly bulletins on the development of his ox. These bulletins were posted on the door of the market for everyone to read. If the farmer gave his friends any other information about the beast, that information was also to be posted on the market door. And anyone who entered the competition who had knowledge about the ox that was not available to the world at large would be expelled from the market. In this way the integrity of the weight-guessing process would be maintained.

Professional analysts scrutinised the contents of these regulatory announcements and advised their clients on their implications. They wined and dined farmers; but once the farmers were required to be careful about the information they disclosed, these lunches became less useful. Some smarter analysts realised that understanding the nutrition and health of the ox wasn't that useful anyway. Since the ox was no longer being weighed – what mattered were the guesses of the bystanders – the key to success lay not in correctly assessing the weight of the ox but in correctly assessing what others would guess. Or what other people would guess others would guess. And so on.

Some people – such as old Farmer Buffett – claimed that the results of this process were more and more divorced from the realities of ox-rearing. But he was ignored. True, Farmer Buffett's beasts did appear healthy and well fed, and his finances ever more prosperous; but he was a countryman who didn't really understand how markets work.

International bodies were established to define the rules for assessing the weight of the ox. There were two competing standards – generally accepted ox-weighing principles, and international ox-weighing standards. But both agreed on one fundamental principle, which followed from the need to eliminate the role of subjective assessment by any individual. The weight of the ox was officially defined as the average of everyone's guesses.

One difficulty was that sometimes there were few, or even no, guesses of the weight of the ox. But that problem was soon overcome. Mathematicians from the University of Chicago developed models from which it was possible to estimate what, if there had actually been many guesses as to the weight of the ox, the average of these guesses would have been. No knowledge of animal husbandry was required, only a powerful computer.

By this time, there was a large industry of professional weight-guessers, organisers of weight-guessing competitions and advisers helping people to refine their guesses. Some people suggested that it might be cheaper to repair the scales, but they were derided: why go back to relying on the judgement of a single auctioneer when you could benefit from the aggregated wisdom of so many clever people?

And then the ox died. Amid all this activity, no one had remembered to feed it.

INTRODUCTION

Far too much of a good thing

In the City, they sell and buy. And nobody ever asks them why. But since it contents them to buy and sell, God forgive them, they might as well.

Humbert Wolfe, *The Uncelestial City*, 1930

Anyone passing the skyscrapers of Wall Street or the City of London and its annexe at Canary Wharf will be impressed by the scale and scope of modern finance. Logos display familiar names such as Citigroup and HSBC. More discreet brass plates identify organisations that do not deal with the general public. The most important headquarters building in the industry, the head office of Goldman Sachs, at 200 West Street in Manhattan, remains anonymous. The premises are lavish, the limousines ubiquitous. Individuals with offices in the executive suites earn more in a month than most people will expect in a lifetime. But what do these people do? To an extent that staggers the imagination, they deal with each other.

The assets of British banks are around £7 trillion – four times the aggregate of the yearly income of everyone in the country. The liabilities of these banks are a similar amount. The assets of British banks are five times the liabilities of the British government. But the assets of these banks mostly consist of claims on other banks. Their liabilities are mainly obligations to other financial institutions. Lending to firms and individuals engaged in the production of goods and services – which most people would imagine was the principal business of a bank – amounts to about 3 per cent of that total (see Chapter 6).

Modern banks – and most other financial institutions – trade in securities, and the growth of such trade is the main explanation of the growth of the finance sector. The finance sector establishes claims against assets – the operating assets and future profits of a company, or the physical property and prospective earnings of an individual – and almost any such claim can be turned into a tradable security. 'High-frequency trading' is undertaken by computers which are constantly offering to buy and sell securities. The interval for which these securities are held by their owner may – literally – be shorter than the blink of an eye. Spread Networks, a telecoms provider, has recently built a link through the Appalachian Mountains to reduce the time taken to transmit data between New York and Chicago by a little less than one millisecond.

World trade has grown rapidly, but trading in foreign exchange has grown much faster. The value of daily foreign exchange transactions is almost a hundred times the value of daily international trade in goods and services. The annual volume of payments processed in Britain is £75 trillion: about forty times Britain's national income. Trade in securities has grown rapidly, but the explosion in the volume of financial activity is largely attributable to the development of markets in derivatives, so called because their value is derived from the value of other securities. If securities are claims on assets, derivative securities are claims on other securities, and their value depends on the price, and ultimately on the value, of these underlying securities. Once you have created derivative securities, you can create further layers of derivative securities whose values are dependent on the values of other derivative securities – and so on. The value of the assets underlying such derivative contracts is three times the value of all the physical assets in the world.

What is it all for? What is the purpose of this activity? And why is it so profitable? Common sense suggests that if a closed circle of people continuously exchange bits of paper with each other, the total value of these bits of paper will not change much, if at all. If some members of that closed circle make extraordinary profits, these profits can only be made at the expense of other members of the same circle. Common sense suggests that this activity leaves the value of the traded assets little changed, and cannot, taken as a whole, make money. What, exactly, is wrong with this common-sense perspective?

Not much, I will conclude. But to justify that conclusion, it will be necessary to examine the activities of the finance sector and the ways in which it does, or might, make our lives better and our businesses more efficient. Assessing the economic contribution of the industry is complex, because there are many difficulties in interpreting reported information about the output and profitability of financial sector activities. But I will show that its profitability is overstated, that the value of its output is poorly reported in economic statistics, and that much of what it does contributes little, if anything, to the betterment of lives and the efficiency of business. And yet many things that finance could do to advance these social and economic goals are not done well – or in some cases at all.

Modern societies need finance. The evidence for this is wide-ranging and conclusive, and the relationship is clear and causal. The first stages of industrialisation and the growth of global trade coincided with the development of finance in countries such as Britain and the Netherlands. If we look across the world today, statistical evidence associates levels and growth of income per head with the development of finance.[1] Even modest initiatives in facilitating payments and providing small credits in poor countries can have substantial effects on economic dynamism.

And we have experienced a controlled experiment of sorts, in which Communist states suppressed finance. The development of financial institutions in Russia and China was arrested by their revolutions of 1917 and 1949. Czechoslovakia and East Germany had developed more sophisticated financial systems before the Second World War, but Communist governments closed markets in credit and securities in favour of the centrally planned allocation of funds to enterprises. The ineffectiveness and inefficiency of this process contributed directly to the dismal economic performance of these states.

A country can be prosperous only if it has a well-functioning financial system, but that does not imply that the larger the financial system a country has, the more prosperous it is likely to be. It is possible to have too much of a good thing. Financial innovation was critical to the creation of an industrial society; it does not follow that every modern financial innovation contributes to economic growth. Many good ideas become bad ideas when pursued to excess.

And so it is with finance. The finance sector today plays a major role in politics: it is the most powerful industrial lobby and a major provider of campaign finance. News bulletins report daily on what is happening in 'the markets' – by which they mean securities markets. Business policy is dominated by finance: the promotion of 'shareholder value' has been a mantra for two decades. Economic policy is conducted with a view to what 'the markets' think, and households are increasingly forced to rely on 'the markets' for their retirement security. Finance is the career of choice for a high proportion of the top graduates of the top schools and universities.

I will describe the process by which the finance sector has gained such a dominant economic role over the last thirty to forty years as 'financialisation'. This ugly word provides a useful shorthand description for a historical process that has had profound implications for our politics, our economy and our society.[2] I shall also use the term 'global financial crisis' to describe the events of 2007–9 and their consequences.[3]

However, this is not another book about the global financial crisis: it is a book about the nature of finance and the origins of financialisation. Major changes in social and economic organisation are generally the combined product of a rise in the political influence of particular social groups, the promotion of a supportive framework of ideas and a favourable overall conjuncture. That is how the modern market economy came into being, how democracy took root and how over the twentieth century socialism rose – and declined. That process explains the other major economic development of my lifetime: the expansion of the scope of the market economy from a population of fewer than a billion people to one that, for better and worse, embraced half the people of the globe. In the first part of this book I will describe the political changes, the intellectual framework and the wider technological and economic shifts that brought about financialisation.

A remarkable feature of the global financial crisis is that most people in finance seemed to regard it as self-evident that government and taxpayers had an obligation to ensure that the sector – its institutions, its activities and even the exceptional remuneration of the people who work in it – continued to operate in broadly its existing form. What is more remarkable still is that this proposition won broad acceptance among politicians and the public. The notion that finance was special was uncontroversial, and the inability of many intelligent people outside finance to understand quite what financiers did only reinforced that perception.

But finance is not special, and our willingness to accept uncritically the proposition that finance has a unique status has done much damage. All activities have their own practices, and those who engage in them have their own language. Every industry I have ever dealt with believes its characteristics are unique, and there is something in this, although never as much as those who work in them think. But the financial sector stands out for the strength of this conviction. The industry mostly trades with itself, talks to itself and judges itself by reference to performance criteria that it has itself generated. Two branches of economics – finance theory and monetary economics – are devoted to it, a phenomenon that Larry Summers mocked as 'ketchup economics' – the exercise of comparing the price of quart and pint bottles of ketchup without regard to the underlying value of the ketchup.[4] Summers – variously brilliant academic, US Treasury secretary under Bill Clinton, dethroned president of Harvard, director of Barack Obama's National Economic Council and rejected candidate for chairman of the Federal Reserve Board – is a figure who will appear several times in this book.

Summers's derogatory references to 'ketchup economics' deny the unique character of finance and reject the view that a different and specialist intellectual apparatus is required to understand the nature of financial activity and the operation of financial markets. This book reiterates Summers's challenge. Finance is a business like any other, and should be judged by reference to the same principles – the same tools of analysis, the same metrics of value – that we apply to other industries, such as railways, or retailing or electricity supply. I will not hesitate to draw lessons from these industries.

The perspective that views finance as just another business invites us to ask 'What is finance for?' – the question that dominates the second part of this book. What needs does the industry serve, viewed from the perspective of market users, rather than market participants? Financialisation has led to a substantial increase in the scale of resources devoted to finance. More people have been paid more. But what has happened to the *quality* of financial activity?

Finance can contribute to society and the economy in four principal ways. First, the payments system is the means by which we receive wages and salaries, and buy the goods and services we need; the same payments system enables business to contribute to these purposes. Second, finance matches lenders with borrowers, helping to direct savings to their most effective uses. Third, finance enables us to manage our personal finances across our lifetimes and between generations. Fourth, finance helps both individuals and businesses to manage the risks inevitably associated with everyday life and economic activity.

These four functions – the payments system, the matching of borrowers and lenders, the management of our household financial affairs and the control of risk – are the services that finance does, or at least can, provide. The utility of financial innovation is measured by the degree to which it advances the goals of making payments, allocating capital, managing personal finances and handling risk.

The economic significance of the finance industry is often described in other ways: by the number of jobs it provides, the incomes that are earned from it, even the tax revenue derived from it. There is a good deal of confusion here, discussed in Chapter 9. But the true value of the finance sector to the community is the value of the services it provides, not the returns recouped by those who work in it. These returns have recently seemed very large. In all the thousands of pages that have been written about the finance industry in recent years, very little space has been devoted to one fundamental question 'Why is the industry so profitable?'

Or perhaps the relevant question is 'Why does it *appear* so profitable?' The common sense that suggests that the activity of exchanging bits of paper cannot make profits for everyone may be a clue that much of this profit is illusory: much of the growth of the finance sector represents not the creation of new wealth but the sector's appropriation of wealth created elsewhere in the economy, mostly for the benefit of some of the people who work in the financial sector.

And yet, although the finance industry today displays many examples of egregious excess, the majority of those engaged in it are not guilty or representative of that excess. They are engaged in operating the payments system, facilitating financial intermediation, enabling individuals to control their personal finances and helping them to manage risks. Most people who work in finance are not aspiring Masters of the Universe. They are employed in relatively mundane processing activities in banking and insurance, for which they are rewarded with relatively modest salaries. We need them, and we need what they do.

So the third part of this book will be concerned with reform. Structural reform, not regulation. I will explain how the regulation which has been applied with more and more intensity and less and less effect through the era of financialisation is part of the problem – a major part – not part of the solution. There has not been too little regulation, but far too much. What is needed is an entirely different regulatory philosophy. We need to give attention to the structure of the industry, and the incentives of the individuals who work in it, and to address the political forces that have prevented the application of regulatory and legal sanctions that have existed for decades, even centuries. We should put an end to the seemingly endless proliferation of complex rulebooks which are even now beyond the comprehension of the far too numerous regulatory professionals.

The objective of reforming the finance industry should be to restore priority and respect for financial services that meet the needs of the real economy. There is something pejorative about the phrase 'the real' – meaning the non-financial – economy, and yet it captures a genuine insight: there is something unreal about the way in which finance has evolved, dematerialised and detached itself from ordinary business and everyday life.

If buying and selling in the City not only absorbs a significant amount of our national wealth but also occupies the time of a high proportion of the ablest people in society, Humbert Wolfe's complacency – 'since it contents them … they might as well' – can no longer be easily justified. In the final chapters of this book I shall describe how we might focus attention on a more limited finance sector more effectively directed to real economic needs: making payments, matching borrowers with lenders, managing our money and reducing the costs of risk. We need finance. But today we have far too much of a good thing.

PART I

FINANCIALISATION

From the 1970s until the global financial crisis of 2007–8, the financial sector grew in size, revenues and sophistication. The effects were felt by all businesses and households, and there were major consequences for economic policy and the political system. How did these changes come about (Chapter 1)? What claims were made for the benefits of this process (Chapters 2 and 3)? And what were the sources of the extraordinary levels of profit and remuneration that financialisation generated for financial businesses and their senior employees (Chapter 4)?

1
History

The road to Pottersville

A British bank is run with precision
A British home requires nothing less
Tradition, discipline and rules must be the tools.
Without them: disorder, catastrophe, anarchy
In short, you have a ghastly mess.

Mary Poppins, a Walt Disney production, 1964

I was a schoolboy in Edinburgh in the 1960s. The capital of Scotland is Britain's second financial centre and was the headquarters of two major banks, the Bank of Scotland and the Royal Bank of Scotland. Banking was then a career for boys whose grades were not good enough to win them admission to a good university.

The aspiration of many of my contemporaries was to join either 'the Bank' or 'the Royal Bank'. With appropriate diligence, they might, after twenty years or so, become branch managers. The branch manager was a respected figure in the local community, and social interaction at the golf club or Rotary lunch was part of his job. He would know personally the local professionals – the accountant, the lawyer, the doctor, the minister and the more prosperous tradesmen. The bank manager would receive their savings and occasionally make loans. The regional office might review his figures, but would rely heavily on the manager's assessment of character. He – there were no female managers – expected to spend his career with the bank, and to retire with a pension. It never crossed his mind, or the minds of his customers, that the institution he had joined at the age of seventeen would not continue for ever, in broadly its existing form.

A little later, I began my career teaching in an institution that still believes that it will continue for ever in broadly its existing form: Oxford University. Few of my students then contemplated careers in the City of London, and those who did were generally less academic but socially well connected. If you had told me that within twenty years many of the best and brightest of Oxford students would spend more time preparing applications and seeking internships and interviews at City firms than they did in the library, I would have reacted with disbelief.

When my friends were joining the Bank or the Royal Bank, and I was beginning the study of economics, it was possible to believe that the historic problems of financial instability had largely been solved. There had been no major financial crisis since the Great Depression, and the failure of a major financial institution seemed inconceivable. My schoolmates were the last generation to aspire to fill the shoes of George Banks, the bank manager in *Mary Poppins*, who returned home at 6.01 each evening and expected his pipe and slippers at 6.02.

It is probably not a coincidence that the cinema celebrated the traditional bank manager – who was simultaneously figure of fun and pillar of the community – at precisely the moment such characters were being ushered from the stage. *Mary Poppins* was released in 1964. In the UK the television series *Dad's Army*, a comedy about the wartime Home Guard, was a popular hit between 1967 and 1974; its lead character was the pompous, unimaginative, honest bank manager Captain Mainwaring. Frank Capra's film *It's a Wonderful Life*, though much admired when first released in 1946, was nevertheless a box office flop; but in the 1970s it became a Christmas favourite with US television audiences, and has remained so ever since. The hero was Jimmy Stewart as George Bailey, manager of the Bedford Falls savings and loan institution. Banks, Mainwaring and Bailey epitomised the role my classmates expected to assume.

That was about to change. In a scene at once comic and shocking, Bailey is shown by his guardian angel how the world might have been without him. Bedford Falls has been renamed Pottersville, after