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Financial Culture

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Introduction

- Deng Xiaoping: "Finance is very important. It is the nucleus of the modern economy"
- Finance and the economy: which is of primary importance?
- What is the public interest in finance?
- Has the public interest in finance been well served by the financial system?
- Are the financial authorities doing a good job in promoting the public interest in finance?
- Problematic culture in finance
- A recipe for reform

Back to Basics in Finance

- Mobilization of money from those who have it to those in need of it to facilitate the effective conduct of economic activities
- Mismatch of risk appetites of investors and risk profiles of fund raisers; doubtful ability for them to assess and price risks
- Need for financial intermediaries with expertise to match risks through the transformation, transfer and transaction of risks (financial intermediation)
- Traditional channels of financial intermediation – banking, debt and equity
- Role of financial markets – liquidity and price discovery

Public Interest in Finance

- Stability – mobilization of money in a stable manner; no disruption to economic activities
- Integrity – no one should be taken advantage of unfairly or cheated in the process
- Diversity – choices of channels through which money is mobilized in support of the economy; “spare tires” in the event of disruption
- Efficiency – investors to get attractive risk-adjusted returns and fund raisers have ready access to inexpensive money (a low intermediation spread)

Private Interest in Finance

- Users of financial services – private interest aligned with public interest
- Providers of financial services – in market-based financial systems, private interest of financial intermediaries is the maximization of profits for financial institutions and remuneration for those running those institutions (a high intermediation spread)
- Conflicting interest in finance – balancing this conflict is a political process, particularly in democratic societies; outcome seems problematic; recurrence of financial crises

Current Public Policy Stance in Finance

- Market-based approach to mobilization of money preferred over decisions made by bureaucrats
- Public interest in finance not clearly articulated in the relevant laws governing finance
- Recognition that protection is needed for those not in a position to protect themselves, particularly small investors and depositors
- Narrow focus of financial authorities in regulation of financial markets and supervision of financial institutions
- Use of public money to rescue financial institutions in difficulty and heavy penalties for institutional and individual misconduct

Behaviour of Financial Intermediaries

- Abusing privileged positions (influence over where money comes and goes; access to financial markets) for institutional gain, neglecting the true purpose of their existence
- Keen proprietary involvement in "investment banking" where quick and large amounts of money can be made
- Playing the financial market zero sum game and expecting to win all the time. Who are the winners and at whose expense?
- Competitive pressures in a largely free market environment encouraged innovation and complexity, creating unknown and systemic risks

Proprietary Trading

- Investment banks betting depositors' money on complex derivative products – for example, sub-prime CDO – and losing much of it in the 2007-08 financial crisis
- Enactment of the Dodd-Frank Act in the US to implement the "Volcker Rule" to ban proprietary trading, amongst other things
- Effectiveness of Dodd-Frank Act is doubtful with key exemptions allowed – underwriting, market making related activities, risk mitigating hedging, etc.
- Donald Trump's intention concerning the Dodd-Frank Act

Financial Innovation

- Financial innovation to be welcomed if it serves the public interest
- Track record doubtful
- Motivation behind financial innovation is more profit maximization than effective mobilization of money
- The example of securitization of sub-prime mortgages: fee-based “originate and distribute” model, erosion of underwriting standards, correction of residential property market, financial crisis
- The example of financial derivatives: enhancement of efficiency of price discovery or exacerbation of volatility? effective hedging instrument or gambling device? the tail wagging the dog? ease of market manipulation and predatory attacks?

Financial Infrastructure

- The financial infrastructure (payment, clearing, settlement, custodian, trading platform, etc.) a public good analogous with the physical infrastructure
- Not in the interest of financial intermediaries to have an efficient financial infrastructure for the mobilization of money in the economy
- Pro-active public sector involvement or reliance on market initiatives?
- Transparent, dedicated and non-profit making market platform or over-the-counter?
- Why, for example, financial market clearing and settlement norm is still T+2 and not RTGS DvP or PvP?

Politics of Finance

- The mighty Wall Street
- He who determines where money comes from and where money goes can influence votes in a democracy
- Inevitable effect of job mobility between public and private sectors on attitude of financial authorities
- Easy for the authorities to echo the opinion of financial intermediaries, wave the free market banner and argue for leaving matters to the market – a neglect that has proven not to be benign
- Difficult to identify market failure and make a case for government involvement in the provision of financial services or intervention in financial markets

Incentive and Behaviour of Employees

- Strong emphasis on mandates for employees in financial institutions on revenue generation, particularly for traders
- Compensation structure correspondingly awards revenue generation, with bonuses or variable pay being in multiples of fixed pay
- Compliance, risk management, integrity, etc. are de facto only of secondary importance to individual employees, not to mention satisfaction of clients or effective mobilization of money
- Incentive system and pressures to meet targets encourage misconduct

Individual Misconduct

- Unauthorized trading against established regulatory requirements, industry codes of conduct, and firm-specific limits on trading, market making, etc.
- Market manipulation – attempts to move market prices and to influence the fixing of benchmark prices
- Collusion with other service providers
- Cheating customers on what the prevailing price is in markets to which the firm has privileged access
- Traders testifying in court: “I wanted every bit of money I could get because that’s your performance metric, that’s how you’re judged”; “if you are not cheating, then you are not trying hard enough”

The Cost of Justice

- Imprisonment of a handful of individual culprits
- Huge multi-billion fines for financial institutions
- (Possibly politically-inspired) criminalization of financial institutions; with non-prosecution agreements or deferred prosecution agreements to force sustained improvements
- Much tighter and intrusive regulatory requirements for monitoring, surveillance and compliance
- Big Brother (George Orwell - 1984) approach is expansive and expensive
- Who pays?
- Big Brother approach versus tackling cultural problem

Yam's Hypothesis

- Current culture in finance creates inter-temporal shifts in the intermediation spread and breeds financial crises
- Two approaches to the measurement of the intermediation spread charged by the financial system: difference between funding costs of those needing money and investment return of those with money IS(U) and total operating costs (including profits, bonuses, compliance and legal costs, penalties, etc.) of financial intermediaries IS(P).
- Over time, IS(U) = IS(P); short-term differences possible due, for example, to shifts in monetary policy stance; IS(P) > IS(U) possible only through inter-temporal transfer; persistent phenomenon a prelude to a sharp widening of IS(U) in the context of a financial crisis

Recipe of Reform for Financial Authorities

- Articulate clearly what is the public interest in finance and how it is to be safeguarded, and widely publicize them to achieve political support
- A review of the adequacy of relevant laws and mandates for financial regulators and supervisors to act in the public interest as defined
- While accepting that the market is superior in the efficient allocation of financial resources, a recognition that markets can and do fail and a readiness to take appropriate preventive or corrective action
- Ensure that complexity and innovation are consistent with the public interest and be prepared to block questionable initiatives
- A more pro-active attitude towards the development of the financial infrastructure
- A more immediate need to intervene in compensation practices and operating models of financial intermediaries to remove incentives for misconduct and ensure that they deliver what they are licensed for

Recipe of Reform for Financial Intermediaries

- A humble recognition of the purpose of their existence and the specific functions that they need to perform in return for the privileged positions that are protected by their licences
- A clear focus at all levels and in all operating models to serve well the economy through effective mobilization of money amongst their customers
- Stop proprietary trading
- Transparently charge for financial services provided rather than taking on clients' orders as principals
- A new compensation arrangement whereby employees are remunerated principally on the basis of how well they serve customers, with incentives for misconduct removed
- A willingness to cooperate with the authorities to construct a financial infrastructure that best serves the public interest

Conclusion

- Finance is very important. It is essential for prosperity in (but not the nucleus of) the modern economy
- Market-based approach to finance superior, but cultural revolution in finance needed to harness financial market potency rather than a continuing reliance on Big Brother
- Internationalization makes harmonization of policy stance difficult: laws are domestic (and changes require political support) but financial markets are international
- Not optimistic about quick improvement
- In the meantime, debilitating financial crises will, regrettably, recur