Tomorrow's Finance

Of Markets and Men

Tomorrow's Finance lecture, 14 May 2012

by James Featherby

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James Featherby has worked in the City for over 30 years. He is currently chair of the Church of England Ethical Investment Advisory Group. Formerly, he was a corporate partner of Slaughter and May for more than 20 years.

James is the general editor of *'Global Business and Human Rights'* and the author of *'The White Swan Formula: rebuilding business and finance for the common good'*. His new book *'Of Markets and Men'*, calling for an integrated reform of culture and finance, will be published in the summer.

He speaks here in a personal capacity.

But, Mousie, thou art not alone,
In proving foresight may be vain:
The best laid schemes o' Mice an' Men
Go oft awry,
And leave us nought but grief an' pain,
For promised joy.

Robert Burns. Extract from "To a Mouse"

It seems strange that on a Monday afternoon so many folk want to think about finance. But I'm guessing that you're representative of many others who, like you, know deep down in their gut that something's wrong.

How do we go about fixing something when we're not quite sure what the problem is, or which solutions might work best? And there's one thing we can be sure of. The world is never going to become less complex or less unpredictable. I'd like to suggest that there are some things we can do to make a very substantial difference – so long as we're prepared to unearth good principles and then have the courage to apply them.

There are five points I'd like to make this afternoon.

The first is that our finance reflects our philosophy. If we want to change finance we as a society need to change the way we think. We've done it before. The Reformation of the 16th century. The Enlightenment of the 18th century. No lesser change is needed now. To be specific, our thinking – in this suddenly globalised planet – needs to become more relational, more holistic, more neighbourly, more adventurous, more purposeful, more humble and more principled.

My other four points are the outworkings of those principles. In brief they are these. One, mega-businesses, those businesses that control the way in which we live, to be given a civic responsibility as well as a private purpose. Two, levels of personal, corporate and national debt to be permanently and materially reduced. Three, what I call 'claims-based trading' to be significantly curtailed. And four, the introduction of what I call 'bi-productive investment'. Savers helping to create not just a better financial future, but a better financial, social and environmental future.

But let's return to the issue of philosophy.

When the financial crisis first hit us, there were no end of technical reasons being given as to why it had happened. Trade imbalances, regulatory failings, inadequate financial models, and so on. Only one human failing contributed, so it was said – the greed of bankers. This seemed to me to vastly short-change the depth and complexity of the human issues involved, both inside and outside the City. So I was delighted when the debate moved on to 'cultures and behaviours'; a recognition that there was a broader malaise.

Where do these two debates sit now? I'm afraid they sit in isolated and unconnected pockets. Technical fixes being worked on over here. 'Cultures and behaviours' being worked on over there. What needs to happen, but hasn't yet happened, is an appreciation of the feedback loops between, on the one hand, the infrastructure of business and finance and, on the other hand, the cultures of which they are a part.

Positive values help to create positive institutions, and positive institutions help to foster positive values. Sadly, it's also true that negative values help to create negative institutions, and that negative institutions help to foster negative values. Some want to go back to business as usual; the same financial architecture, just slightly nicer people running the show. Believe me that won't happen, and in fact I believe can't happen.

I believe we need to reach a position in which our positive values are changing the very nature of our business and financial institutions. If we don't, the strength of their objectives and products will continue to overwhelm us.

Western culture has changed considerably since Adam Smith. We have become more individualistic, more reductionist, more utilitarian, more fearful, more disparate, more arrogant and more pragmatic.

- Our focus on the individual has morphed into a belief that the interests of all are best served if we each pursue our own interests. According to this logic, there's no point seeking the welfare of others because it's only my own welfare that matters.
- The scientific method has developed into a creed that dividing issues into their constituent elements is the best way to analyse them. This has diminished our systemic understanding and, crucially, as a result has made us myopic as to the consequences of our actions on others.
- Just as economics has come to dominate all policy decisions, so utilitarianism, the belief system of economics, has come to dominate our moral imaginations. The value of others has been diminished to one of usefulness to us.
- We naturally fear for provision and protection. But living alongside others who've become increasingly individualistic, reductionist and utilitarian has increased these fears. We're responding by rejecting trust and seeking to control both others and our futures, rather than learning to respond to their inevitably chaotic and unpredictable natures.
- Our attachment to freedom of choice has left us unable to agree on a common destination. As a result we've lost the Aristotelian and Judeo-Christian understanding of development towards personal and societal fulfilment. Our rightful fear of judgementalism has left us unwilling to discern between what's helpful and harmful on that journey of development. We're a bit obsessed about doing our own thing. Our disparate objectives makes a common goal very difficult to identify, let alone achieve.
- Our technical progress has made us over-confident. We've made the mistake of transposing to economic and social theory the certainties of science. We believed the efficient market hypothesis. We thought that by creating more financial activity we were creating a more perfect market, and we thought that a more perfect market would produce more beneficial outcomes.
- And our disquiet over notions of right and wrong, our increasing lack of trust, and our belief that policies must be evidence-based, has left us unwilling to believe that universal principles are a sound basis for good decision making. We no longer trust that – on average and over the long term – positive results flow from making decisions based on positive principles.

Business and finance, including the debt and equity capital markets, have come to reflect these trends in many ways. I believe we need to reverse them philosophically and practically. The four practical steps I'm suggesting are designed to help do this.

But before I go on, can I emphasise that mine is not an anti-business agenda. Far from it. As even Pope Benedict has said, the creation of wealth is an inescapable moral duty. It's business that creates the jobs, wealth and taxes on which we all depend. Not one of the points I'm about to make is anti-business. Nor am I arguing against evidence-based decision making. What I am saying is that we need more humility about our supposedly scientific looking facts and conclusions, at least in economic and social theory. In the space which that humility creates, if not beyond, lies the room for principles-based decision making.

So let's look at these four practical steps in a bit more detail.

First of all, mega-businesses. In brief, I believe that mega-businesses should be given an appropriate element of civic duty to sit alongside their private purpose. Company law around the world is remarkably consistent about the nature and purpose of companies. Specifically, their definition of success means that they're legally required to be self-centred. And society grants their shareholders, through the free gift of limited liability, immunity from the normal principles that apply in a civilised society – namely, full responsibility for actions taken on their behalf.

To the extent that the interests of other stakeholders are considered at all, they're only considered to the extent that they contribute to the success of the company, rather than because of their own intrinsic value. Cost and risk – financial, social and environmental – are externalised as far as possible, and usually not even measured.

This is modern Western philosophy in action.

This may not matter in many cases, but in some cases I believe it matters a lot. Mega-businesses, the very new kids on the block in terms of human history, have come to control the way in which we live – whether that's how we receive our energy, use our transport, finance our businesses, buy our food, make our payments or store our information. Given that they're self-centred, utilitarian, and focussed on shedding responsibility, this is worrying enough. But mega-businesses also pose particular risks because of their size.

It's not just that with their behavioural mapping and huge advertising budgets we've become unable to resist their advances. They also pose problems in terms of systemic risk, competency, business resilience, financial risk, lack of diversity and undue political influence.

The conclusion I've reached is that it's time to reset the contract between society and mega-businesses, whether they be UK or foreign, in relation to their UK operations.

Supermarkets to promote nutritional welfare. The media to tell the truth. Banks to promote the financial health of customers. Oil companies to promote clean energy. And so on.

Let’s move on to look at debt.

It’s clear that we’ve got too much of it. We need to have less of it. The policies designed to make banks safer don’t address this issue of quantum. They’re designed to make banks safer, not to make the rest of us healthier.

Debt does of course have its advantages, but excessive debt has caused the financial economy to grow way out of proportion to the size of the real economy. The total sum of the debts we owe is greater than the total worth of what’s pledged against it, whether in terms of assets or reliable future income.

We need, I believe, to re-think our addiction to debt. Excessive debt results in an inevitable transfer of wealth from poor to rich, and so also an inevitable centralisation of power. It therefore multiplies inequality. It is just as much the cause of excessive pay as globalisation and technology. It creates inflation and economic instability, the effects of which are felt hardest by the less well off. It fuels unsustainable levels of consumption, with consequent implications for pollution and natural resource use, not to mention its partnership in the never-ending cycle of consumer want, momentary satisfaction, closely followed by more consumer want.

Excessive debt creates inter-generational unfairness. It prioritises asset price growth, and therefore encourages speculative investment seeking merely capital gains, irrespective of productivity or utility improvement. In turn, and because of the structure of executive remuneration packages, this has encouraged financial engineering and unwise M&A activity rather than the creation of permanent value. Because debt seeks security it doesn’t favour a knowledge or innovation economy, which is a real concern in an economy like ours.

Excessive debt is often unfair on third parties when combined with limited liability structures. And it enables profligate public finances. Excessive debt produced a credit economy whose collapse was probably inevitable sooner or later. Its demise has led to an unsustainable, and highly centralised, central bank money economy. Governments, central banks and a relatively small number of private sector banks are now locked into a dangerous embrace as they seek to manage the economy to stabilise each other rather than necessarily serve the public interest.

One concern among many is that the equity markets are now being driven, not by the fundamentals of the real economy, but by the steps this small cabal are taking to preserve their own liquidity and solvency. This is damaging to the process of efficient capital allocation, and may yet provide some rude shocks for savers. As the chief economist of Deutsche Bank has put it, the next shift may be *“discontinuous.”*

You might wonder where all of this debt came from. The answer is frighteningly simple. Private sector banks, quite literally, create money out of nothing. A touch of the button is all that’s needed. And for every pound of money they mint, another pound of debt is created. Money and debt are the opposite sides of the same imaginary coin. Putting one’s trust in an illusion usually leads to trouble, and so it has.

So I believe that we need to take radical steps to substantially deleverage the levels of personal, corporate and national debt in the UK economy. And we need to make that permanent by decommissioning the machinery that produced it, so that we can’t manufacture it again.

The following might be some of the milestones along the way:

- imposing the loan-to-value and loan-to-income restrictions put on hold by the Financial Policy Committee because of a certain shyness about so directly telling the public that debt is bad for one's health
- removing the right from private sector banks to what's called 'seigniorage' – the right to create money and debt almost without limit
- reversing the subsidy given by one set of tax payers for the tax deductibility of interest paid by another set of taxpayers – and in the process reversing the tax disadvantage currently applied to equity funding
- considering a move to full reserve rather than fractional reserve banking
- indeed, considering a move to an asset-backed currency before whatever confidence remains in our current fiat money is suddenly and irretrievably lost, or by-passed by businesses reverting to barter
- and imposing semi-constitutional limits on the powers of government to run unsustainable budget deficits.

But what, you might say, about the connection between leverage and growth? It is of course ridiculous to imply, as some have done, that there is a straight-line connection between leverage and growth. For instance, with equity and debt taxed on an equal footing, debt/equity refinancings would become more attractive. And of course growth can be achieved in other ways too. Cutting red tape, making it more attractive to hire staff, encouraging UK businesses to invest their record levels of cash, and more locally based investments by pension funds and insurance companies, would all offset the effects of de-leveraging.

And who wants growth anyway where, as we have seen, most of the benefits of growth are captured by so small a percentage of the population?

Let's look now at 'claims-based trades'. What do I mean by that phrase?

I mean all of those contracts and securities – and whether relating to underlying equities, fixed income securities, commodities, indices or whatever – that create largely zero sum rights to claim against third parties. Their size is colossal. A popular estimate puts their size at US$ 600 trillion. That's 40 times the size of the US national debt, itself no small figure. That's a huge amount of capital poised to sue rather than co-operate.

But it's not necessarily size that's the problem. 'Claims-based trades' and debt have something common. They both create economic relationships that are less than fully interested in the wellbeing of the real economy. Both debt and 'claims-based trading', unlike genuine equity investment, provide for a fixed entitlement to reward – except in the case of insolvency.

As a result, they both tend to be divorced, first of all, from the economic wellbeing of their counterparty and, secondly, from the health of the economy in which that counterparty operates and which might otherwise help that counterparty to flourish.

The lender, or seller of the trade, can simply sit back and receive his cash flows, blissfully imagining that he has controlled the future. US$ 600 trillion is a huge commitment to aim in the direction of something other than the good of the economy.

This is fundamentally different to equity. With equity, the investor's return depends entirely and directly on how well the borrower does, and on the strength of the economy and society that supports that borrower. With equity, the investor is incentivised to care.

This divorce in economic concern is, I believe, both an intellectual and a societal mistake. It doesn't just isolate the lender from the borrower, it creates financial activity that is focussed on extracting maximum reward without any accompanying motivation of contribution. It encourages business models, and cultural values within the sector, that seek to extract rather than serve the interests of clients. It seeks to justify trades and products by reference merely to the profit of market participants, and without reference to their societal or market consequences. And if you're looking for reasons as to why investment bankers missed the signs of the 2007 financial crisis, you need look no further. An industry that's disconnected from the welfare of society makes poor business judgements.

It's also questionable whether much of the 'profit' created by all this activity is in fact real. The combination of significant volumes of invented money created by fractional reserve banking, with significant quantities of 'claims-based trades', creates a huge cloud of financial, non-real assets. Market trading allocates the resultant profits and losses, which net out broadly to zero, between the individual savers who are the ultimate end-owners of all investments. In other words, you and me.

In the process, little has been achieved in the real economy, or for savers when looked at as a whole, except for the capture by the financial services sector of fees for having expanded, shuffled and re-dealt the deck of cards.

The justification for all these trades is often assumed to be increased liquidity. And there is, of course, a need for a level of trading to create and support the market. But it's questionable whether much of the sector's activity adds much, if anything, to the process of either price discovery or liquidity. However, my point is not that it's socially useless. My point is that it's socially damaging for at least three reasons.

First, because of the rents extracted by the sector. These come from asymmetric information and deeply embedded options likely to cause large but occasional losses for investors and taxpayers.

Second, because fundamental values are in danger of being obscured rather than clarified, and diversification of risk is becoming more difficult to achieve. This is because correlation levels between and across sectors are at unusually high levels, caused in no small measure by huge volumes of 'claims-based trades' and the use of leverage, and because volatility is welcomed due to the profit opportunities it provides for traders.

And third, 'claims-based trades' are socially damaging because of the systemic risks they pose when taken together – risks which both traders and regulators admit they can neither track nor control.

My conclusion is that we need to reduce permanently and materially the amount of debt-fuelled speculation in the market, including trading on margin calls and through stock lending, And we need to reduce substantially the level of 'claims-based trading', whether leveraged or not.

We might also return to some good old-fashioned principles about gambling. Trades that in substance are *"games of chance (which may also involve skill) for a prize"* are unhelpful both for gamblers and society. They should, as a matter of public policy, be legally unenforceable.

Exceptions could be made for financial products where the regulators have been persuaded of two things. First, that the products will not result in unacceptable risks to the market if adopted on a broad basis. And, secondly, that the products provide material benefits to end-savers, borrowers and the real economy – rather than simply to market participants.

May I turn now to my fourth and final practical step for helping us integrate positive values into the infrastructure of finance: rediscovering the purpose of investment.

Can I start by telling you a quick story? A friend of mine recently gave his daughter a large sum of money.

She went to see an investment manager – who being a bright fellow spotted that she had a strong social conscience. So most of the conversation was about the things that she should not invest in. When the young woman got home she said to her father, *"Dad, all he talked about was what not to do with my money. But what I want to do – is to do something useful with my money."*

I think the issue she was raising was a fundamental one.

As investors, we've come to see the market as simply the place where we slap our money on the table looking for maximum reward commensurate with risk. We don't think very much at all about what our money is financing or about whether that's good for us, or the society in which we live.

I'd like to propose instead what I call 'bi-productive investment'. 'Bi-productive' because it's productive twice. Once, at the other end of the investment chain, in terms of producing a social benefit through the companies in which I'm invested. And once, at my end of the investment chain, in terms of producing a reasonable financial return for me.

These two things, rather than being mutually inconsistent, are in fact mutually reinforcing. It's a both/and investment strategy, not an either/or one. Because, of course, the value of most companies is their goodwill; the value of their relationships with employees, customers and suppliers. In other words, the value of the very social benefit that we would be trying to encourage.

What might this look like in practice? Given the choice between two rough equals, I'd invest in the bank that was doing most to help customers budget and save. Given the choice between two rough equals, I'd invest in the oil company that was investing most in clean energy. Given the choice between two rough equals, I'd invest in the mining company with the best health and safety record.

This isn't about investing in what some call the 'social-impact sector'; those businesses that have a charitable or semi-charitable purpose, although I'm all for that.

What I'm suggesting is that we re-configure our understanding of the market in two ways. First, we'd see the market as a place where we could try and help create a better future. We'd be deploying our capital to try and help create the kind of society that we'd like our kids to grow up in. And secondly, the market would be re-connected to the most basic principle of business: the paradox of profit.

Business makes a profit by focussing, not on making money, but on serving customers. Business gives in order to receive. Under 'bi-productive investment', the same paradox of profit would produce a financial return for me as I focussed, first of all, on something else: putting capital to productive use.

I'd stop trying to squeeze the last pip out of the lemon in terms of financial return, not least because I'd know that relentless returns for me meant a relentless business culture for others and the environment beneath me. Instead I'd be more interested in the long term.

It would be for each of us to decide, perhaps according to our appetitive for adventure and the size of our resources, how much of this journey was for us. Some might rightly decide that they still needed to maximise returns. For others, the call might be to risk more in the short term in exchange for a longer-term goal.

This last, and fourth, practical step is mostly down to us as the individuals who are the ultimate end-owners of all capital. It's primarily about our personal motivations when we invest. But the markets do need further democratisation to empower us. And there are three regulatory changes that would help us.

First, we should require listed companies to produce social and environmental reports, in much the same way as financial accounts, reporting on both positive and negative impacts, and with the reports, prepared according to consistent measures and independently verified.

Second, we should require the financial services industry, including insurance companies and pension funds, to advise us on the social and environmental, as well as the financial, implications of our investments.

And third, we should require the financial services to create the technology necessary to enable us, as individual savers, to express our views and preferences through appropriate aggregating mechanisms. Amongst other things, this would also leap frog the current debates about the fiduciary duties of trustees being just to maximise financial returns.

What might we see develop as a result? A financial services sector that employs social scientists as well as rocket scientists. Beneficial changes in corporate behaviour. Investors more connected with their investments.

Creating jobs in the North East, improving nutrition levels in our local supermarket, funding the development of high-tech manufacturing in the Thames Valley would all feature more highly on our list because of the interests of our children and grandchildren.

We'd probably have less diversified, more manageable portfolios. Our portfolios would become more local, less global. We'd see more clearly the connection between our investments and the health of the national community of which we are a part.

There would, of course, be increased costs in the short term. But would the bigger picture reveal, for example, lower UK taxes because of lower UK welfare benefits? Lower National Health Service bills because of less stress? Stronger GDP because of higher investment in productivity? Who knows? But in any event, you can't have responsible stewardship without the costs of stewardship.

So allow me to make just a few brief observations in closing. It all starts, and mostly ends, with how we think. We must take back our imaginations and believe that we can think differently.

Let's return to sound principles as a sound basis for good decision making. Let's develop a philosophy, both individually and institutionally, that is more relational, more holistic, more neighbourly, more adventurous, more purposeful, more humble, and more principled.

Let's help ourselves do this by:

- giving mega-businesses a civic responsibility as well as a private purpose
- reducing levels of personal, corporate and national debt, permanently and materially
- curtailing claims-based trading significantly, and
- becoming savers who are helping to create not just a better financial future, but a better financial, social and environmental future.

And let's find a new metaphor for business. The invisible hand is past its sell by date, not least because these days the picture it paints is too individualistic. How about business as jazz? An orchestra of different players, each weaving their harmonies into the rhythm of the whole. Every participant aware of and responding to everyone else. Each instrument making its own unique contribution. One song. Many voices.

We have a window of opportunity now. Let's not lose it.

Thank you for listening so patiently.

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