Does Finance Benefit Society?

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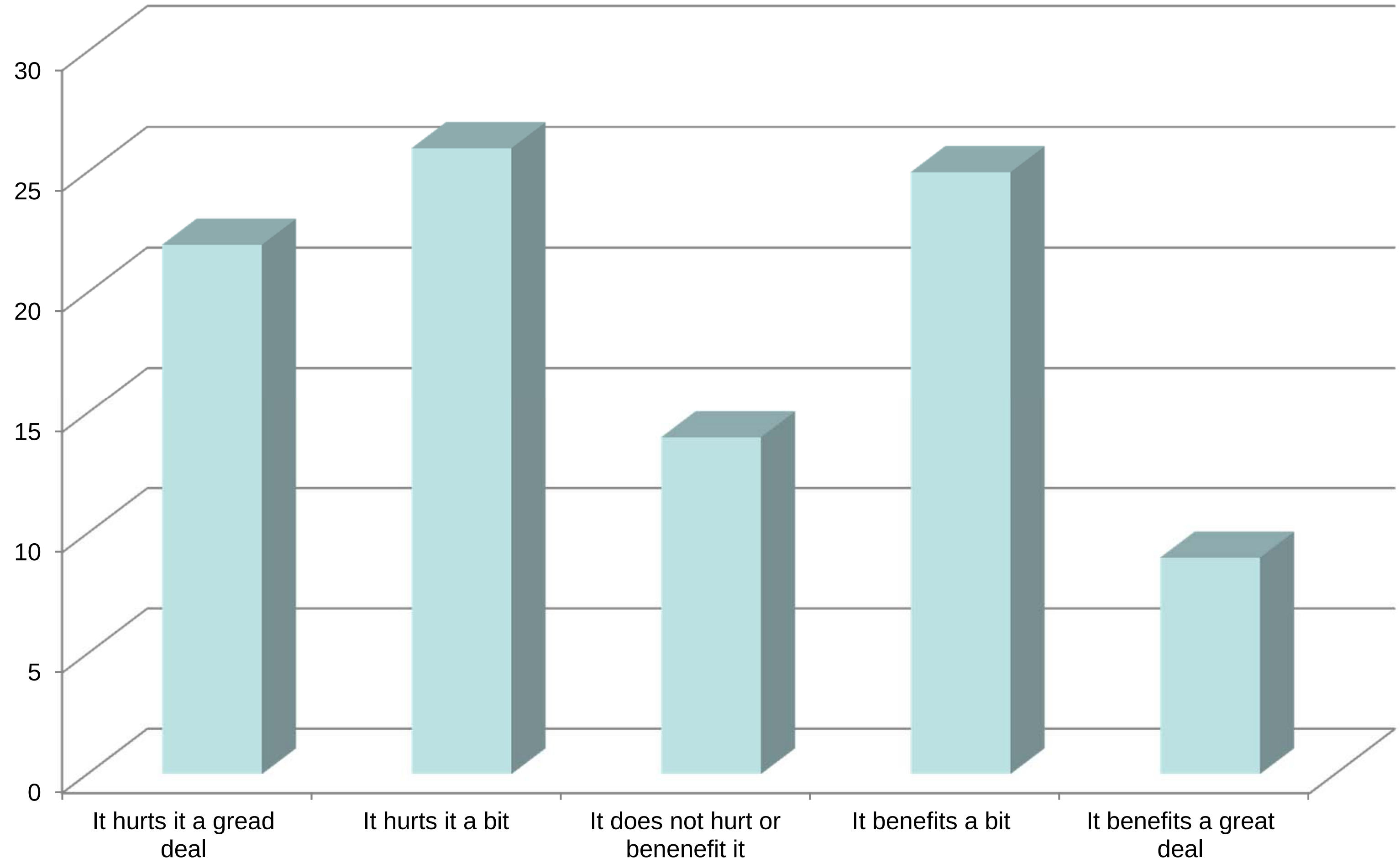
- In 2010 *The Economist* organized a debate

- House statement was

"financial innovation boosts economic growth."

57% voted no

Overall, how much, if at all, do you think the US financial system benefits or hurts the US economy?



Should we care?

- Every business suffers greatly from a negative public image
- Finance is particularly exposed to political interference
- Competitive market-based finance particularly so

Vicious circle

Challenge to the rule of law

Finance seeks political support to operate

Only the less competitive part succeeds

It corrupts the system more

Strengthening populist rage

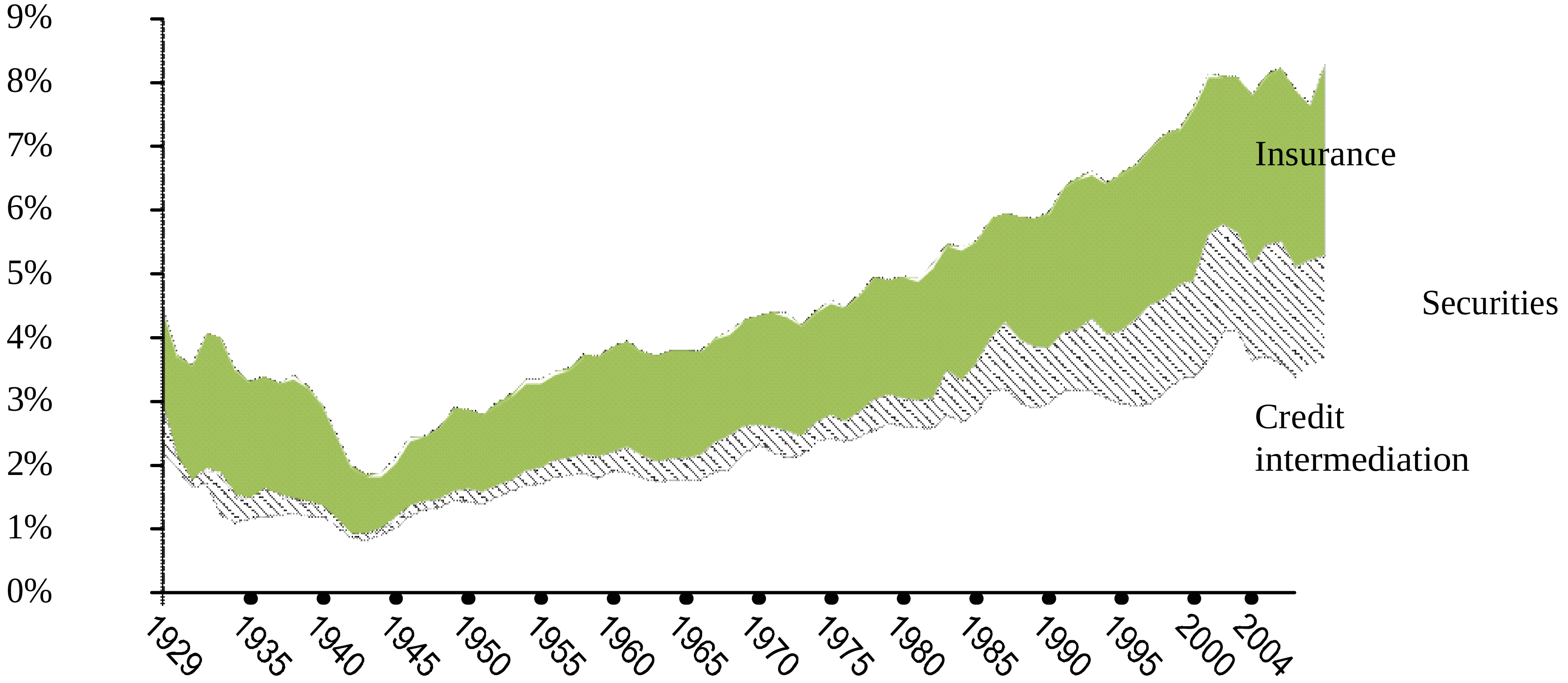
It can happen

- It happened in the United States during the Great Depression
- It happens around the world (Di Tella and MacCulloch (2009))
  - within a country, those who perceive widespread corruption also tend to demand more government intervention
  - increases in corruption in a country precede increases in populist voting
- It starts happening here again

Who is to blame?

- The public, who does not understand, or us, who are too embedded in our own field?
- Probably both
- Either way we are responsible for closing this gap
- What can we do?
  - Explain and document better the benefits of finance
  - Do a bit of introspection. Where does this confidence that all finance is good come from?

Growth of Financial Services



Source: Greenwood and Scharfstein (2013)

1. Can we argue from theory?

2. Can we argue from evidence?

3. Can we argue by analogy?

1. Can we argue from theory?

- First Welfare Theorem
- Incomplete markets
- Hart (1975) and Elul (1995)

There is <u>no</u> theoretical basis for the presumption that financial innovation, by expanding financial opportunities, increases welfare.

2. Can we argue from evidence?

- Even severe critics (Stiglitz,’10) agree that
  – a good financial system is essential for a well-functioning economy
  – “over the long sweep of history, financial innovation has been important in promoting growth”
- The real matter of contention is whether
  – Financial innovation over the last 40 years has been useful
  – The size of the U.S. financial system today is excessive.

2. Can we argue from evidence?

Intermediation (Credit/GDP):

- Evidence summarized in Levine (2005) speaks to the average, not marginal effect
- Arcand et al. (2011) find a non-monotone relationship between credit to GDP and growth, with the tipping point at 80-100%
- Schularick and Taylor (2012) go further and establish that lagged credit growth is a highly significant predictor of a crisis
- Similarly, Mian and Sufi (2014) for debt/GDP

2. Can we argue from evidence?

Equity market and derivatives:

- A bit of evidence for equity market (Levine and Zervos,1998)
- Almost no evidence for other markets

- Sherlock Holmes principle:

“when data available, lack of published evidence can be safely interpreted as evidence of lack of an effect”

3. Can we argue by analogy?

- Between 1960 and 2012, while the financial sector grew from 4% to 8% of GDP, the healthcare sector grew from 5% to 18%
- Both sectors
  - provide a service everybody needs, but very few people understand
  - depend heavily on trust
  - are plagued by conflicts of interest
  - experience abuse and fraud
  - are much bigger in the United States than in most other countries

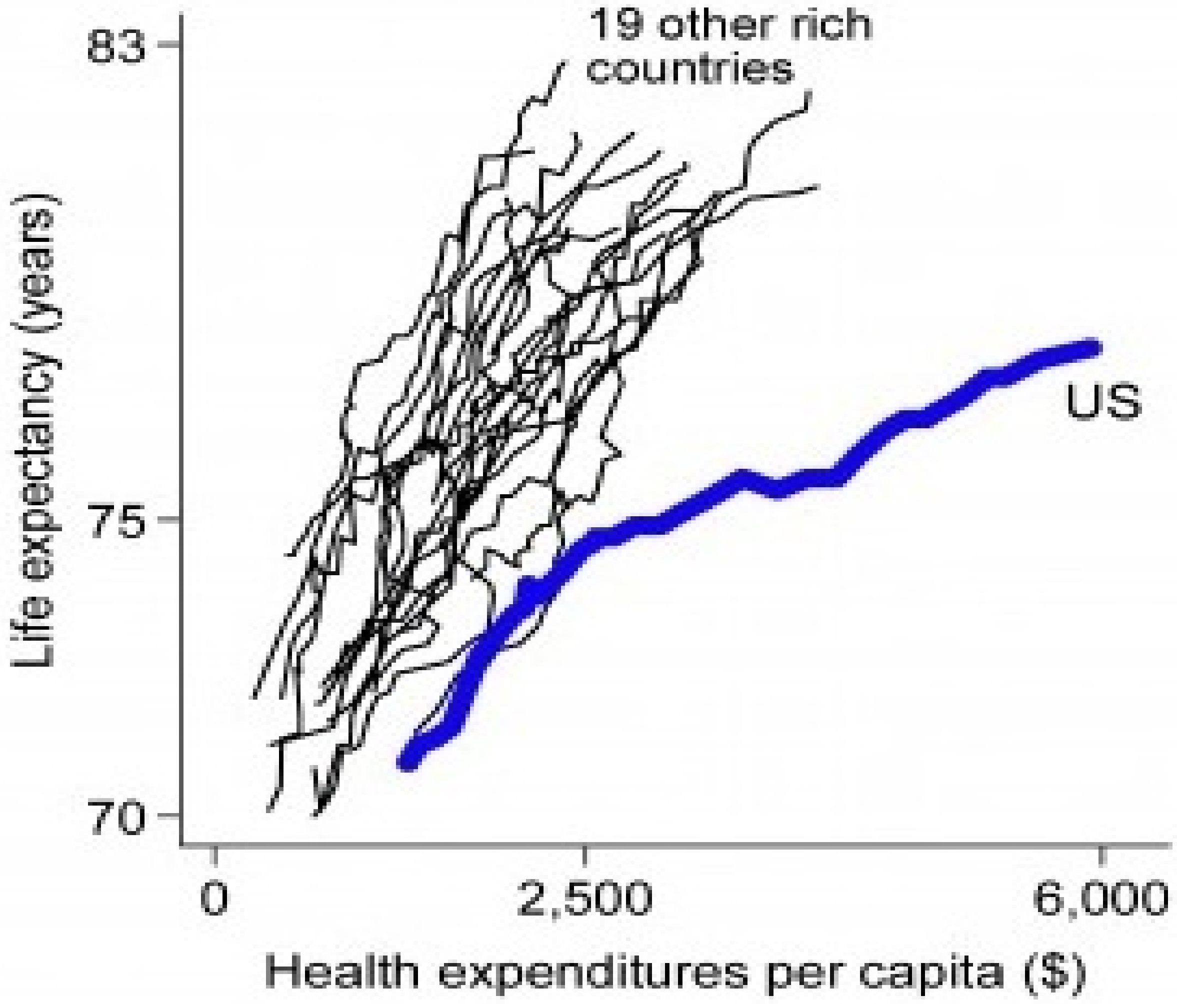
Money Doctors

- Gennaioli et al. (2014) argue that finance is a service, like medical services. While expensive, not using this service is even worse because most people do not know much about these fields.
- Supported by Von Gaudecker (forthcoming), who shows that financial illiterate workers benefit from financial advice: they gain roughly 50 bps of extra return per given level of risk.

Is healthcare a positive analogy?

- The question is not whether we benefit from doctors, but what is the cost-to-benefit ratio
- In the U.S. healthcare expenditure is 18%, almost twice that of the UK (9%) and Sweden (10%)
- Disproportionate size does not map into measurable benefits:
  - The U.S. is 32nd for overall life expectancy below Portugal and Greece, in spite of spending more than four times as much per capita

Is healthcare a positive analogy?



Are we better off?

- In Sweden the share of finance over GDP is half of that in the United States
- Are U.S. retirement savings managed so much better than Swedish ones?
- The evidence in Cronqvist and Thaler (2004) seems to suggest not.

Implication

Having failed to find any compelling reason for such an explosion of finance, we need to entertain the alternative:

possibility of some rent-seeking

1. Duping investors
2. Aiding and abetting agency problems
3. Outright fraud
4. Self-serving government intervention

1. Duping investors

- Two types of duping:
  - straight duping :
    - Celerier and Vallee (2013): retail structured products
    - Ben-David et al. (2015): mortgages sufficiently complicated not to be understood by borrowers
  - indirect duping (shrouding): Gabaix and Laibson (2006)
    - teaser-rate mortgages
    - credit cards
- So widespread that even the government does it (Swagel, 2009)

Swagel (2009)

“ A key insight is that under pricing insurance coverage is economically similar to overpaying for assets—but it turns out to be far less transparent. This insight underpins both the TALF and the bank rescue programs announced by the Obama administration in March 2009.”

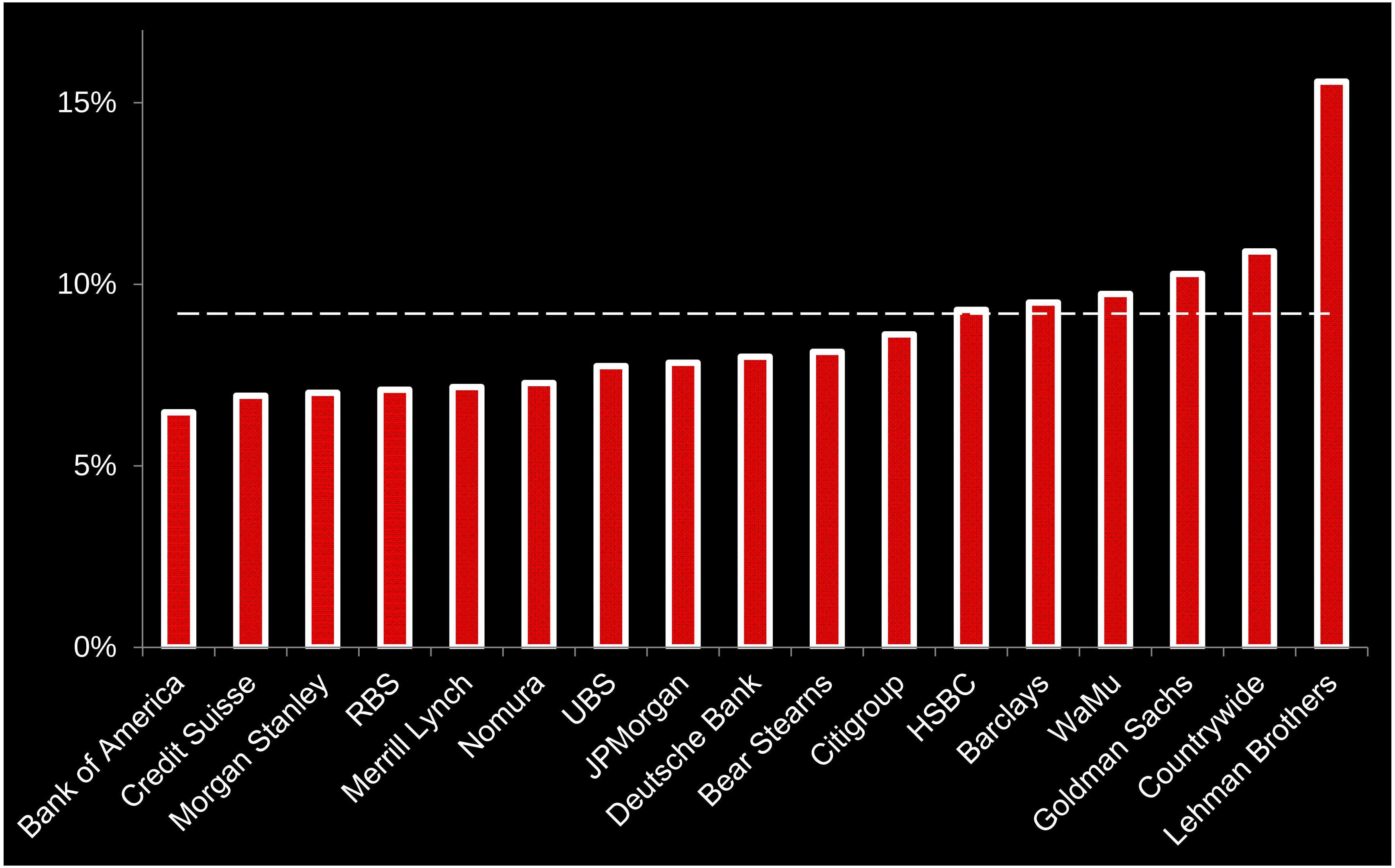
2. Aiding and abetting

- Many buyers of financial products are agents (including elected politicians)
- Financial products are often designed to please agents at the expense of the principals
- Principals can try to limit it contractually, their success depends upon
  - speed of innovation
  - flexibility of the technology
  - how present and active the principal is
- Finance stands out on all three dimensions

3. Outright fraud

- Dyck et al. (2014) estimate that cost of (mostly financial) fraud among the U.S. companies with more than $750m in revenues is $380bn a year.
- In 2012-14 financial institutions paid $139bn in fine, $113bn of which for mortgage fraud.
- A whistleblower inside JPMorgan: 40 percent of the mortgages of some RMBS were based on overstated incomes (Querner, 2014).

Pervasiveness of fraud



Source: Piskorski et al. (2013)

Banality of fraud

- Royal Bank of Scotland employees' emails

Senior Yen Trader: the whole HF (hedge fund) world will be kissing you instead of calling me if libor move lower

Yen Trader 1: ok, i will move the curve down 1bp maybe more if I can

Senior Yen Trader: maybe after tomorrow fixing hehehe

Yen Trader 1: fine will go with same as yesterday then

Senior Yen Trader: cool

Yen Trader 1: maybe a touch higher tomorrow

- There is no attempt to hide it, no sense of guilt. It is ordinary business.

4. Government interventions

- Bailout options:
  - Kelly et al. (2012): a collective guarantee for the financial sector valued at more than $100bn
  - Fannie and Freddie:
    - Ex ante $13.6 billion a year
    - Ex post $180 billion
- These are not the results of populist pressures against the interest of the financial industry, but subsidies to the financial industry

Consequences

- High margins + free entry -> excessive entry, bloated sector.
- Hsieh and Moretti (2003) demonstrate it for real estate agents by using the variation in land (not house) prices across U.S. cities.
- Areas with more expensive land have more real estate agents.
- Very difficult problem to eliminate if the source of the high margins is not eliminated.

What can we do?

- Traditional response: more government regulation
- Regulation is part of the problem, not necessarily part of the solution
- What can <u>we</u> do?
  1. In our empirical research
  2. In our theoretical research
  3. In our teaching

1. Empirical research:

A. Act as whistleblowers

- Remarkable examples:
  - “collusive” quotes on NASDAQ (Christie and Schultz, 1994)
  - postdated stock options (Lie, 2005),
  - inflated prices in house sales (Ben-David, 2011)
  - disappearing analysts’ recommendations (Ljungqvist et al. , 2009).
- Not enough, why?

B. Ex post analysis of innovation

- Payday loans: research identified both positives and negatives
- Colorado experiment
  - Cap on rates + installment loans
  - Borrowers paid 44% less in interest
  - But received more credit
- Why?
  - Before there was too much entry
  - After, half of the stores closed

2. Theoretical Research

- All researchers are affected by fads, ideology, and biased by interests (Kuhn, 1962)
- We economists are not different, but we have one advantage:
  - rigorous framework of analysis
- We should apply this advantage in policy proposals with three caveats:
  1. Be rigorous not policy relevant
  2. Policy $\neq$ Politics
  3. KISS

Examples

1. Shift in the liability rule (*Caveat Venditor*) for all but the simplest financial products.
2. Extending aiding and abetting rules to regulatory arbitrages.
   – Possibly with an efficiency exception
3. Mandatory disclosure of financial accounts “derivative-free”.

3. In teaching

- Moral standards in the financial world seem to be very low. Is it just selection?
  - Wang et al. (2011): the teaching of economics makes students more selfish.
  - Cohen et al. (2014): bank employees behave more dishonestly when their professional identity is rendered salient.
  - Not true for other professional identities or bank-identity for other non bank employees.
- Are we training people to be (more) dishonest?

3. In teaching – cont

- We teach just positive analysis:

A crime is committed when

expected benefit > expected cost

- But we label irrational someone who does not commit a crime under this condition
- Most people label such behavior as moral
- Being agnostic are we subtly teaching students the most amoral behavior without taking any responsibility?

3. In teaching – cont

- We need to bring social norms into our regular MBA classes.
- At the very least in the form of business reputation
  - see UK reaction to news of Starbucks' tax dodging news
- Markets are based on social norms too.
- If we do not teach them to our students, we risk undermining the very institution we all support

Conclusions

- I believe that a good financial system is essential to prosperity and freedom.
- Creating and sustaining such a system is not easy.
  - Broad public support is necessary
- Unfortunately, in the U.S. we have lost much of this support and it will not be easy to regain.

Conclusions - cont.

- As finance academics we can make a difference
- At stake is not our reputation, but our future.
  - If finance becomes a business of political relationships, there is no scope for our teaching services, there is no room for us.
- I am sure you disagree with many points, but I hope you agree with the importance of this matter and with some of the solutions