

Good Finance

Why we need a new concept of finance

Summary

Societies need finance for economic welfare, and progress is almost impossible without a well-functioning financial system. After the industrial revolution, countries with more effective financial systems developed faster and today the global landscape of economic well-being evinces this historical fact. However, since 1980s, misoriented waves of deregulation led to a giant industry of finance, size of which cannot be explained by any measure of economic growth and global trade. Today, finance has mostly turned into a game in itself and often become more harmful than useful for societies. Unless we reset our concept of finance to serve its essential purposes for the good of the whole society, the future of global social order will be under a continual threat of chaos.

Key messages

- Size of financial markets and level of global financial flows are too much to be explained by real investment and trade. By and large, origins and trading of financial assets are often disconnected from real economic activity.
- There is too much debt and too little equity in corporate, household and public finances. Too much debt is a call for defaults, crises, and subsequent social trauma.
- The financial system has become too complex and opaque, hindering good corporate governance and effective supervision.
- Despite all technological advances and lessons from recent financial crises, academia and policy makers resist to update their mindsets and tools.
- Global discussion at all levels is imminently necessary to reassess the role of finance in our lives. We must reform finance and we can do it.

Problems with finance

Since the 18th century, capitalism has led to remarkable gains in prosperity, standards of living, and technological innovation. However, as the system moved away from its basic pillar of free-market economics, it has also produced major problems. Environmental damage, increasing inequality in income and wealth, loss of public trust in institutions, and “financialization” are the major problems facing humanity today. Finance is special in that it is both a problem in itself and also an enabler of other problems. Financialization refers to the phenomenon of financial industry being much bigger in size than real economic activity can justify.

- Today, the world has too much finance, as easily evinced with a few numbers. Global size of financial assets is almost \$400 trillion, which may be compared with a global GDP of about \$85 trillion, global non-financial wealth of about \$140 trillion, and a global trade volume of \$45 trillion. Since 2007, global notional value of traded derivatives has been around \$700 trillion. Underlying value of derivatives trading on major commodities is often more than 15 – 20 times of physically existing quantities. Even without considering

derivatives activity, the ratio of cross-border financial flows to trade flows is almost 10 in advanced economies and 6 world-wide. Fast growth of finance is mostly a phenomenon of the past 40 years and it is no coincidence that number of financial crises during the period is greater than the total number of such events during the preceding 400 years. Finance industry is also peculiar in that there seem to be no economies of scale as the average cost of financial intermediation has been around 2% for many decades now.

- Although all agree that the primary cause of financial crises is too much debt, global debt of all types continue to increase. It has reached almost \$300 trillion today, twice the level during the 2008 crisis. Since 2008, bank credit has been reduced in some countries but it has increased in other countries and non-bank credit (bonds and credit by shadow banks) has more than replaced the decrease in bank credit. On the other hand, equity financing lags far behind debt financing. Global total market value of public equity has reached about \$80 trillion after an unprecedented bull market since 2009, which is still less than one-third of global debt. Except in China and Japan, public offerings of new equities and number of publicly listed companies have declined considerably. The world not only has too much finance but also too much debt and little equity.
- The turn of the century also marked the start of unleashed derivatives trading. This has resulted in obvious increases in both price levels and also price volatilities of major commodities. This is bad news for net consumers, who make the majority of world's population. Credit derivatives, on the other hand, were seen to have served no good purpose but pouring gas on the small flame of subprime mortgage defaults in 2007 to turn it on a global fire.
- Since 1980s, the global financial system has become very complex and opaque. Today, the distance between households and corporations has increased over an almost untraceable path with multiple layers of intermediation and also non-intermediary parties. Financial technology can engineer almost any risk-return package under a very sophisticated title, which regulators and rating agencies often cannot fully comprehend on time. In response, governments have increased the sizes of regulators to design similarly complex regulations. Regulating complexity with complexity runs the risk of an unstable and self-destructive equilibrium in the long run. Complexity precludes effective corporate governance and supervision of conduct. Bad governance and ethics eventually result in loss of investor confidence and short – termist business behaviour.
- People in finance, both in academia and also in practice, are almost blinded with overreliance on complex models, all of which are based only on a tiny subset of mathematics. Solving a mathematical problem is often perceived as a solution to a financial problem, when, in fact, it has nothing to with real life and often no social use. The economic and political elite, on the other hand, often underestimate the power and consequences of financial technology and engineering. Despite all we have lived in the first two decades of the century, most still believe that financial markets can be controlled via central banking and regulation formatted as lists of rules. They seem to ignore the fact that financial markets can often mitigate any intended impact of monetary policy and regulation, which can also produce undesirable consequences as in the 2008 crisis.

After a decade into the global financial crisis, all and even more of the reasons that led to the crisis are still much alive today. More scaringly, policy makers, regulators and market players have started to behave as if the crisis never happened. Central banks, financial regulators, banks, fund managers, audit and rating companies resist to update their models and tools. This is an example of the memoryless property of financial history, which may be linked to natural human psychology.

Despite global will to deleverage after 2008, debt has continued to increase, maybe in a more disguised form now than before and under other new names. Despite all policy goals, tax codes and regulations are largely left untouched and favor debt financing against equity financing.

Despite all the initial enthusiasm, regulation is still fragmented, both domestically and also internationally. There is still no globally binding regulatory framework and even a framework for conflicts of laws. The composition of international standard setters still fail to consider the changing gravity of global economic power. The morally disturbing implicit public guarantees for ‘too-big-to-fail’ institutions are still very much live. In short, business as usual continues, but now with bigger numbers and more deeply rooted seeds of problems. It does not take genius to predict that the next financial crisis will be bigger and more destructive.

Good Finance

In order not to have recurrent financial crises, which are always socially damaging and cause political instability, the world needs a new paradigm of finance. We need to formulate a new “social contract” between regulators / policy-makers and financial markets / people. This contract should redefine the role of finance in our lives and the real purpose of regulation and economic policies.

- Any financial contract with unfair terms of sharing risks and returns between two parties is bound to end with eventual default of either side. Most modern debt and debt-based contracts are so, and this is probably what is meant by “the dark side of debt.” All past crises have proven this fact. Therefore, the choice between debt and equity must be re-studied. All public policies and regulation must be clear on reducing dependence on debt and leveling the playing field between debt and equity. Household debt for short-term spending on consumption should not be encouraged.
- Widely used models of risk are largely mathematical and they carry the risk of missing structural changes in markets and mathematically unmeasurable uncertainties of geopolitics, natural events, changes in social behaviour, technological disruptions and the like. The distinction between mathematically modellable risks and mathematically unmeasurable uncertainties must be made clear and a new holistic approach to risk management must be developed.
- Financial regulation should favor long-termism against short-termism. This calls for effective stakeholder engagement for good corporate governance and accepting that supervisors cannot do what stakeholders should be doing for themselves. In particular, pension funds, insurance funds and mutual funds should not be “pushed” to be short-termist. Integrity and care for reputation must be incentivized by regulation, directly or indirectly.
- Central banking should be re-positioned to pay due attention to other public policies and financial regulation, reformulate monetary policy to consider the inner structures of the real economy, and recognize that most relations in today’s markets are systemic and interconnected. Monetary policy and fiscal policy must work in harmony, and all have to be significantly revised in light of new facts.
- Although financial literacy of ordinary people may be good, this popular approach cannot even get close to achieving the desired goal of disciplining the industry. What the world needs is not a population good in counting money, but properly educated financial

professionals to properly manage other people's money. This calls for an overall revision of financial education at universities. We should teach students standard finance, mathematics and technology, maybe even at more advanced levels than today. But, most importantly, we should first teach why finance exists in societies, its purposes and functions, and how they are expected to serve the society at large.

Conclusion

The financial industry has evolved into a self-serving complex system sustainable only through a continually increasing supply of credit. The first step towards good finance is to break the growing vicious cycle of credit and debt. Short of this, regulation can never save the system, and it will always have to save the firms at the expense of the people. In a properly regulated industry, fates of firms are determined in free markets, not by governments. A functional approach to regulation is much needed.

As two parties who disagree cannot agree on what they disagree, we cannot design a model of good finance without redefining the basic reasons for why finance exists as a discipline and practice. We must show the courage to question the existing assumptions and set of tools of finance and economics. This book hopes to be a first step to this end.

About the book

Good Finance by Vedat Akgiray is published by Bristol University Press on 5 June, 2019.

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Vedat Akgiray is currently a Professor of Finance and Director of the Center for Corporate Governance at Bogazici University in Istanbul. He directed the doctoral program in finance from 1992 to 2009, the M.S. Program in Financial Engineering from 2002 to 2009. He has advised more than eighty graduate students, published and presented more than one hundred academic papers. From 2009 to 2013, he served as the Chairman of the Capital Markets Board of Turkey. He led the team designing and writing the new Capital Markets Law of 2012. During his tenure at the CMB, he also served on the IOSCO Board, the FSB of G20, and the Monitoring Board of the IFRS Foundation. He actively participated in re-designing the international regulatory architecture after the 2008 crisis.