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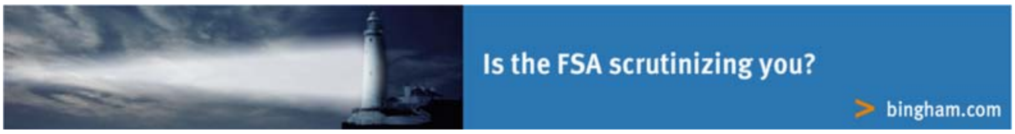


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**Finance and Economics**

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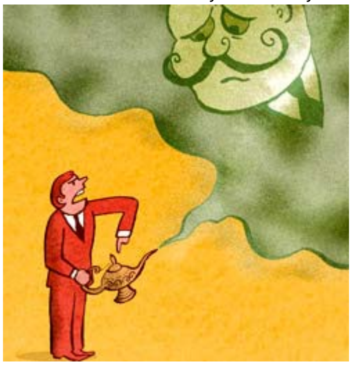
# Too big for its Gucci boots

Sep 10th 2009
From *The Economist* print edition

**The causes of the overexpansion of the finance industry**

Illustration by S. Kambayashi



IT MAY be a year since the fall of Lehman Brothers, but the main questions about the future of the finance industry have yet to be settled. Perhaps the biggest of the lot is whether the industry has become too big for the good of the economy.

Adair Turner, head of Britain's regulator, the Financial Services Authority, recently suggested another way of addressing this question by saying some banking activities were "socially useless". The phrase rightly implies that some of its operations are "socially useful". After all, a year ago, it was feared that if the banking system collapsed, the whole economy would break down.

Banks pool the capital of savers and lend it to companies at longer maturities, allowing them to invest in new factories and so on. They provide cash machines, debit cards and credit cards, enabling the vast majority of commercial transactions to take place. The finance industry provides liquidity to markets, thereby reducing the cost of capital. It allows companies to manage risks, such as sudden shifts in exchange rates, and thus enables more trade to take place than would otherwise occur. And the industry creates a market for corporate control, allowing capital to be moved from inefficient businesses to more efficient ones.

Most of these activities, of course, have been going on for decades, and in some cases centuries. So it seems doubtful that such activities suddenly became a lot more important in recent years. Yet between 1996 and 2007 the profits of finance companies in the S&P500 dramatically jumped from $65 billion to $232 billion, or from 19.5% to 27% of the total.



Other factors were probably at work. Paul Woolley, who set up the Centre for the Study of Capital Market Dysfunctionality at the London School of Economics, argues that this is a classic case of a principal-agent problem. The agents have better information than their clients—pension funds, retail investors and the rest—and the interests of the two groups are often not aligned. It can also be very difficult for clients to tell whether their many agents are doing a good job. A member of a pension fund relies on trustees to manage the scheme. Those trustees pick a consultant, who selects fund managers who might buy structured products from an investment bank. If those products include mortgage-backed securities, then lenders, brokers, property valuers and estate agents will also be involved.

Every agent takes a cut in the form of a spread or commission. But because financial products are complex or long-term in nature, the client may not realise the worst until it is too late. The finance sector is thus able to earn a high level of "rent" at the expense of its customers.

Why are these rents not competed away? Probably because products are not transparent. Consider fund management. This is an industry with few barriers to entry and no firm has a dominant market share. One would expect fees to be driven down remorselessly. In some areas, such as index-tracking, that does happen. But in the retail sector firms compete on the basis of past returns, not price. In the institutional sector fees for traditional fund management have dropped, but clients have been tempted into alternatives like hedge funds and private equity, where fees are much higher. Some financiers have become billionaires as a result.

In the case of banking, the implicit subsidy created by government guarantees (or the expectation of bail-outs in times of crisis) has reduced the cost of capital and thus increased returns.

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The high level of rents extracted by the industry may have self-reinforcing aspects, too. The rents translate into high salaries for employees, encouraging the brightest graduates to join the industry and devise more complex products to gain even higher rents (and to find new ways around regulations). The industry's profitability allows it to gain political influence, either through the funding of candidates or via the desire of governments to protect taxpaying businesses.

All this helps explain why finance grew too big for its boots, even if it is impossible to put a figure on the scale of its overexpansion. Government bail-outs have also prevented the industry from shrinking as much as it might have.

Such intervention means that it is now too late to insist on a purely free-market solution. And the scale of the rescue packages means that finance should pay some price. Governments cannot guess what the right size of the industry should be. But higher capital ratios would protect the taxpayer from future bank failures and limit the industry's profitability, while transparency might reduce the size of those rents.



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