New City Agenda

What They Do With Your Money

5 July 2016

Introduction

Lord Sharkey

David Pitt-Watson is one of the leading practitioners in the field of responsible investment. He was a Director of Hermes Shareholder Stewardship business, which became the largest of any investment fund manager in the world. In 2010 he was a member of the Future of Banking Commission with Lord McFall and David Davis.

Back in 1990, Rupert Pennant-Rea wrote that, 'Many institutional investors care as much about the companies they invested in as a punter betting on the 2.30 at Chepstow; they are passionately interested in what happens to the horse in the next few minutes, but they do not care much about the long-term. They are punters not proprietors. Short-term investors need to focus on the short-term.'

New City Agenda found that in the UK's retail banks, a culture focused on short-term sales led to gross misconduct and misselling, which to date has cost us all over £53 billion in fines and redress. The question is, of course, has this been paid by the executives, in reduced bonuses, for example, and the answer, of course, is no it has not. Largely it has been paid by the bank shareholders and the rest of us.

David's work reminds us that shareholders are not, in fact, some separate class; they represent us and the millions of people across the company who own these companies through our pension funds, ISAs and other investments. He rightly asks the question, 'If millions of us own these companies then why are they not run for our benefit?' If you take executive pay, which seems to increase every year despite talk of a 'Shareholder Spring' – perhaps an example of the case in point – as Andy Haldane of the Bank of England told us when he addressed us at our annual dinner, 'With very few exceptions no differences were made to executive compensation packages as a result of investor action.' Cases of investors actively voting against pay packages have, in any case, been rather rare.

However, it has never been more important to ensure that the investment industry delivers value for money and good long-term performance. Automatic enrolment will mean an extra £11 billion every year will be saved into pensions. Instead of buying an annuity many will take advantage of the new pension agreements by leaving their money invested for longer, perhaps. Yet it seems virtually impossible for even the experts, and here I explicitly include Andy Haldane, to understand how much is being deducted in costs and in charges. To help us and to discuss what they actually do with their money, please welcome David Pitt-Watson.

How the Financial System Fails Us and How to Fix It

David Pitt-Watson

Executive Fellow, London Business School

I. Preamble

Thank you very much. Thank you to the New City Agenda, and thank you all for coming along to this discussion, in these spectacular surroundings. I am an investment practitioner; I used to run the shareholder activist funds at Hermes, and over the past few years have been involved in a number initiatives, a lot of them emerging from the 2008 banking crisis. The Banking Commission chaired by David Davis would be one, another would be taking part in the investigation into why accounting standards failed to show that the banks were in trouble.

II. Critical Purposes

I am now based at London Business School as an Executive Fellow, and in my writing I have worked with a couple of co-authors in the United States, Jon Lukomnik and Stephen Davis. As we were looking at the aftermath of 2008 it seemed to us that no one had taken a step back and said, 'Look, does the finance industry do a good job or not? If it is not doing a good job, why is it not doing a good job?'

If you want to ask these questions, you need first to define what the purpose of the finance industry is, and to be able to evaluate its performance against that purpose. So, we went searching for people who might have done this; who had defined a clear purpose for finance, and measured its performance accordingly. We could find nobody who had started with this very simple logic, and so that was the genesis of the book.

If you start with the purposes of the finance industry, the first thing that you conclude is that they are really fundamental to our economy and our society. There are four really important things that the finance industry does for the outside world: the first is it keeps our money safe; the second is it helps us to transact with one another. The third is it allows us to share risk; that is what an insurance company does; it is what a portfolio manager does as well, if he or she invests your savings in many different companies.

But the most important thing the finance industry does is "intermediation"; that is, taking savings from the real world and investing them again in the real world. Lord Rothschild, Jacob Rothschild's dad, who was a member of the House of Lords, had this lovely phrase that summed it up: 'What you do is you take money from point A, where it is, to point B, where it is needed.' That is what intermediation is—taking money from where it is to where it is needed.

Those four functions are absolutely critical to our economy and our society; so critical that pioneers in finance are often thought of as being philanthropists. The first funded pension fund, for example, (where people put aside their money over years and years and it is paid out when needed) was invented in the 1740s. The founders, Wallace and Webster were two Scottish ministers. They did it for the widows and orphans of other Scottish ministers. It was the first funded pension fund.

We have in recent times awarded the Nobel Peace Prize to only one business person, the financier Muhammad Yunus. Muhammad Yunus: what did he do? He loaned money to poor people, developing “microfinance”. Muhammad Yunus and Wonga technically do the same thing. Muhammad Yunus does it with purpose, which has transformed the lives of millions of people for the better; Wonga find it more difficult to make that claim.

III. Productivity

These four purposes – keeping your money safe, allowing you to transact, allowing you to share risk, and, critically intermediation – are the four critical purposes of the finance industry, and that is the starting point of the book.

If you know that is the starting point you can then start to say: ‘How well is the finance industry doing in performing these tasks?’ In answering this question we have one marvellous study done by a French economist based in New York called Thomas Philippon. He said, ‘Let me assume that the main thing that the American finance industry has done is to intermediate;’ take money from point A to point B. ‘I can measure on national statistics how much money has been saved and how much money has been loaned or invested over time. I know that measuring this over one year or two years is not terribly clever, because you could be making bad loans. I know as well that things have changed over this period of time and I will need to adjust for smaller loans and bigger loans, so I am going to do this over a long period of time; 130 years. I am going to look at how much the finance industry cost and how much it has intermediated, and then I am going to divide one by the other, which will tell me the unit cost of intermediation. I would expect, as we are looking over 130 years, since productivity has increased more than tenfold in the US, to see a huge fall in the cost of intermediation – maybe an 80% fall, which would be half the average productivity benefit being kept by the industry and half going on to its customers.’

That is what you would see in every other industry, but in the financial services industry he found no productivity increase whatsoever.

This was not because the finance industry did not have the enabling technologies; you will hear a lot about FinTech. There have been many technologies we have developed which ought to have helped improve the productivity of the finance industry: information and communications technologies, the internet, the computer, are hugely significant in allowing the finance industry to do its job better. Nor is it because they do not have good people; we hire very clever people into the finance industry. Nor is it because we do not have competition; we have lots competition in the finance industry, and yet the evidence would suggest there has been no productivity increase at all and no net gain for the outside world. As someone who has spent most of their career in finance, I find it utterly galling that all that activity that takes place yet it has produced no net productivity benefit for the outside world.

IV. Regulation

Why is that? That is what we explore in the book. As you go through the book I hope there are things you will agree with. I hope there may be things you would want to disagree with and debate as well. But one of the reasons we suggest for the productivity failure is that we have simply been indifferent to the institutions of finance and to the governance of the industry. We have assumed that a simple combination of markets and regulation will get us there. This is not an objection to markets: I am a firm follower of Adam Smith. Adam Smith was pretty clear about how it was that

markets were supposed to work. He said, 'It is not from the benevolence of the butcher, brewer or baker that we get our dinner; we address ourselves to their self-interest.' So Adam Smith would say that it was self interest and markets that meant he got a good dinner. The purpose to have a good meal, markets a way of achieving that. The purpose is not the market itself, indeed as the evidence shows, in finance markets have not delivered to purpose.

When this has happened, we have sought to solve the problem by adding regulation upon regulation upon regulation. Let me give you a simple illustration from the UK: in 1990 there were 3,000 pages of regulation that covered pensions in the UK. Last time I looked there were north of 80,000 pages of regulation. I would note that during that period of time you might struggle to see a huge improvement in the pensions industry in the UK. Indeed, Andy Haldane, who I think did the last talk for the New City Agenda – he is the policy and Head Economist at the Bank of England – thought that pensions were so complicated now that he could not understand them, which leaves only about five people left better qualified in the country who might.

What we have done is to use only one perspective, that of markets, and then when they fail added vast amounts of regulation, and to ignore everything else that might help improve the system. It is not that markets and regulation are not necessary; it is just that they are not all that there is to be thinking about. In doing so, we have abused financial theory, pulling it out of context where it might be thought to work, instead thinking about it as having absolute prescription.

V. Ecosystem

Instead maybe we should be thinking about the finance industry as an ecosystem, with many parts which interact. We should not try to precisely prescribe what is or is not needed. Rather we might behave like good gardeners do: they wander round the garden and see many things they can do to harness the forces of nature and harness them to good purpose. In the same way, as we tend the financial system we should be trying to frame the forces of the market and guide them in a way which helps the industry deliver to purpose. This is not a grand plan, not a Gosplan approach, but it is a very different way of thinking about the world than what we do today.

When I have made this argument to people over the dinner table, they often said, 'It cannot possibly be the case that, for years and years, we have been doing all this stuff in finance and it has not created any productivity increase'. But it is. If you wanted an analogy, in Adam Smith's day, if you were ill, then the doctors would come along and they would bleed you to make you better. Really skilled people who had trained for years and years would bleed you to make you better; doctors had been doing that for 1,800 years or longer. No one had ever asked the question, 'If you bleed people, is there any evidence that they get better?' As we know, there was none. It was not until we defined the purpose of medicine, and challenged medical practice that things improved. In the same way as we think about the financial system, we need to take that step back that medicine took, and say, 'What is the purpose of this industry and is that being fulfilled?' This is a vitally critical industry to our economy; we cannot solve any of the world's big problems without it, we need to get it to perform its purpose well. Today, the evidence is it performs its job very poorly indeed.

VI. Diversification and Risk

So that is the starting point of the book. But it also looks at why the finance industry is doing poorly and suggests solutions.

One would be that if you look at the financial system you will see lots of cases where we have taken insight from economics and finance, and we have simply abused them. Let me take, for example, the notion of diversification and risk. It is true to say that you will suffer less risk if you do not have all your eggs in one basket. Indeed, we can use formulae that look at the volatility of different securities and help create a lower risk investment strategy. That is a great insight if all else is equal. But what creates real risk is people not knowing the nature of the securities that they are investing in in the first place, and lending to people who are unable to pay back, or investing in equities in companies, which are not going to be run on the shareholder's behalf; that understanding of the underlying asset, and making sure it is well managed is what is required to limit fundamental risk, and after that you can have diversification.

Here is the problem: if all you do is diversify, you will find it very difficult to be a good underwriter and to understand fundamental risk. If your pension fund has invested in thousands of companies – and, by the way, most pension funds will invest in the shares of maybe 5,000 companies – they will find it very difficult to be good owners of those companies. If all your bank does is diversify its loan book, so that it has a bunch of stuff called subprime mortgages that come from the United States, and it has valued them on a mark-to-market basis, you can bet that all statistics based on diversification may tell it that it is much safer, but it may not be. As 2008 showed it can go bankrupt.

So we abuse theoretical insights. I rather like the story of the Queen when she visited the London School of Economics. She was opening some building and she is supposed to have said to the assembled economists, 'What went wrong? Why did no one see this problem coming?' There was a sort of shuffling of feet, and she went on, 'Things had got a bit lax, had they?' Actually, things had not got a bit lax. In 2007, no-one thought the regulation was lax; they thought the banks were safer in 2007 than they had ever been. The reason that they thought that they were safer was because they were well diversified and they were liquid, and they would manage to trade their way out of problems.

What we did was we took a sensible idea called diversification, we abused it, we hard wired it into the way that we regulate the system, and left the rest to markets. No-one has challenged this approach, and we continue with it today. It is not just diversificationwhich is the problem. We mention a few in the book. Another example we think should worry us is the way the derivatives market is pulling apart ownership from economic interest in companies. That is extremely dangerous.

Put simply, like any ecosystem, the financial markets cannot be described just by economic theory. If we try to apply that theory in a world of "asymmetric information" where you and me do not know what is happening to the money that we are putting into the system, that is a recipe for the externalisation of costs. It is also a recipe to remove our savings from us. And by simple observation we can see how there are "tricks of the trade" which benefit the supplier at our expense.

VII. Tricks of the Trade

I call them tricks, because I think they are tricks. Here is one; it is about what is charged to manage your pension or investment fund. That is a pretty important bit of information for someone buying a pension, yet in this country they will never be told the full amount it is costing to run their fund. It is important because, if you are saving for a pension and it costs 1% a year, 25% of your possible pension will disappear in fees; if it costs 2% a year, half your pension will disappear; if it costs 3% a year, two-thirds of your pension will disappear. That is how the arithmetic works. But here is a

still more galling statistic. If you are told it is costing 1% it is probably costing 2%. Why is that? It is because fund managers simply do not declare, as a matter of practice, how much all the trading of shares, and many other costs commissioned and charged to our accounts have actually cost.

That really matters. One of our most sophisticated fund managers in the UK, the Railways Pension Fund, had a bee in its bonnet about costs, and thought they might be significant, and I have to agree with them. They thought they were being charged £75 million to run their £23 billion portfolio; they were wrong. When all the costs were added up, they discovered they were being charged £290 million. Instead of 8% of their annual return disappearing in fees, about a third of their annual return was disappearing in fees. I absolutely commend Rail Pen, because they are one of the few pension funds in the country that know what is happening, and so can manage their investments properly. (I would be pretty sure that the House of Commons pension fund, for example, has no idea how much taxpayer's money is disappearing in fees that they are simply not told about.)

Here is the thing: markets do not work if you do not know how much you are being charged. If expertise is being abused, and if markets will not work, then it is no surprise that we get the results that we see from the Thomas Philippon study. We will not have increases in productivity; we will not have markets working to serve the people that they are supposed to.

Again, in the book we look at many abuses of this sort, but rather than go through them all, let me focus on the huge prize available to us if the finance industry worked well.

VIII. Dutch Pension Model

There is a simple calculation that we do: we imagine three triplets.. One of them goes off to Holland, one of them has their career in London, and one of them has their career in the US, and they all save exactly the same amount for their pension, they all retire on exactly the same day, and since they are triplets they have exactly the same life expectancy. You would expect that they would all have the same pension when they retire and you would be wrong. The Dutch triplet would have a 50% higher pension, partly because of fees, partly because of structures, partly because of institutions, and partly because when the Dutch started thinking about their pension system they said, 'What is it that we are trying to do here? What is the purpose of this pension?' They decided it was to make sure that people had a reliable income from the time that they retired until the time that they died.

They did not decide that it was simply about having a big savings account, as we have done in this country and in the US, and then let a thousand flowers blossom. They managed the institutions so that they could work that way; they thought hard about the governance of pension funds, and how you could best get them to work. As a result they get a 50% higher pension for the same cost. Just to set that in context; we put 6.5% of our GDP every year into private pensions. We could get a 50% productivity increase if we moved to the Dutch system. It depends on how you do the calculation, but let us call it 2.5% to 3.5% increase in welfare/GDP; that is more than the contribution of North Sea oil is worth to our economy. The advantage in welfare terms, from a simple reform like that, would be absolutely huge, and a lot easier than all the effort put into extracting North Sea Oil.

But instead of having a system designed for purpose, we have one which takes or money, and hands it to one agent, who hands it to another, and another, and another. I think in one study we discovered somebody who had tracked 16 agents before your money is finally invested, each of those agents taking a fee, and most of those fees not declared to you. As someone once said, 'Well,

that is the perfect crime, because you manage to take the money and nobody knows that the money is gone.' Whether you call it a crime or not, that is what is happening.

IX. Governance

Within the financial system we are deeply indifferent to the ownership of the companies. We know that, for systems to work, those in power need to be held to account. Yet Paul Myners, our former City minister described the way companies are overseen through the stock exchange as having created 'ownerless corporations'. One of the statistics I came across recently is the mutual fund in the US that advertises itself as looking after your money and being very careful about where it is invested. They spent $135 million advertising to you how well they look after your money. But scratch the surface and you will discover they employ only one person to vote on 10,000 companies that they invest in on your behalf. The imbalance seems a little bit brutal.

We need to get the governance of this system right, as well as thinking about markets, as well as thinking about regulation, and exposing the tricks of the trade, and the abuse of theory. We need to do so because the finance industry is of such vital importance. But we should also do so because the money that circulates in our financial markets is your money. Every single person in this room will have investments that go into a bank, or into a pension fund, or into an ISA, or some sort of other savings. We have the right to demand a better system.

X. Solutions

There are solutions out there. We could know what the costs are that are being used to manage our pension fund, and have an understanding of what that actually might mean for us when we retire. We could get rid of the regulation that stops Dutch-style pension funds from being able to be established in the UK. We could even ask some of our grade-A finance institutions, like NEST, for example, to help promote a Dutch-style pension fund: 50% increase in pensions for the same cost; same welfare benefit as North Sea oil.

We could stop having a daft argument about whether or not banks should have 3.5% or 3.3% equity buffer for their lending; that is way too low for institutions whose purpose is to keep our money safe. If their primary purpose is to keep our money safe then surely we should not be using arcane and inappropriate ways of measuring risk, to pretend that we have understood it. We should not be discussing whether banks are pretty badly financed or very badly financed: they should be appropriately financed, particularly when there is so little cost associated with making them safe.

Here is another idea for reform. Surely if we were demanding a purposeful system we would not have one where every time pension funds want to trade somebody gets between them with a high frequency trade, and takes the margin from it. Years ago there was a practice called front running by brokers, where if a broker knew that your order was coming through and traded ahead of you to benefit themselves we would send them to jail. Yet a high frequency trader will site their computer next to a stock exchange to find your order coming in, find somebody else's order coming in, and in a nanosecond to front-run it. This is simply is not purposeful, but it costs billions and billions of dollars each year to do it, and we have to pay.

We could invent governance institutions and hold them to account in how well they deliver for us. Sometimes we invent these institutions and then ignore them. I have been campaigning for some years to get greater clarity on costs. We had an OFT inquiry and the industry argued that these costs were far too complicated to explain to the customer. What they would do is they would appoint

independent governance committees, full of experts who would make sure that we got a good deal. The independent governance committees were appointed, many of my friends are on them. Yet not one of them decided that, in assessing whether customers were getting a good deal, that it would be a good idea to do a competitive shop and to see whether somebody else was offering you a better deal. It is a bit like going into Sainsbury and saying, 'Well, I know that the bread costs £5 per loaf, but it seems like a good deal, because it is very good bread'. No-one checked whether, down the road, you could have bought it for half the price. So we have institutions which could help solve these issues, but we do not oversee them.

Then we abuse our knowledge. Remember the Queen's question: it was not that things had got a bit lax; it was, to quote the reply she got that, 'Everybody thought that everybody else was doing the right thing and they were relying upon one another.' That is exactly the system that we still have in the finance system. We use exactly the same principles of measures that we use to regulate and control our banks as we did in 2007, and we have never taken a really big step back to ask, 'What is the purpose of all this?'

Today's approach it is flawed and unsafe. We know the purpose of finance, and we can measure its success in fulfilling purpose. If we started from that point we would end up with a vastly more productive finance industry, and a vastly more productive economy.

XI. Conclusion

That is what the book says. When I have done some of these lectures people come back and say, 'It is all very well, but you will get absolutely nowhere with this.' I think that is wrong. I look back to some of the things that have been achieved in improving governance, and getting finance to do a better job, and there are many successful situations where people have taken a stand and said, 'No, we will stand together and we want change here.'

Alastair Ross Goobey, for example – one of your friends, Lord Sharkey, and my old boss – said, 'Look, it is not okay for there to be rolling five-year contracts for directors, so that, when they get fired they take away five years' pay.' (Indeed, what they would do was to make sure that they did get fired, because that was the way that they got five years' pay). We got rid of that, and of many other abuses. But we still have a long way to go.

The prize here is absolutely huge: it is not just markets, it is not just regulation, it is also institutions, it is also governance, and it is also what we as citizens demand "they to do with our money".

I hope this talk has helped as an introduction, and that it, and the book may help draw up a road map as to how all of us might be able to steer this system this in a better direction.

Questions and Answers

Andrew McNally, Equitile

It does not relate specifically to your cost of intermediation argument, my deep interest is pension funds. There has clearly been, for want of a better word, de-equitisation of pension funds, which I would argue is the result of the application of false theory to the actuarial approach. The Bank of

England, arguably has exacerbated that. How do we resolve that, because what it means is that the savings institutions with the longest time perspective, (pension funds) are not investing long term?

David Pitt-Watson

I think that is right; I think the first thing we have got to do is note that the purpose of a pension is to pay you a predictable income in the future.

Of course, that, at its simplest, is why it is that everybody has gone for "liability-driven investment".

There is a little section in the book on 'This is the next things that are going to go terribly wrong for us'. Liability -driven investment is in that section. Why? Because it is done by looking at the letter of the contract of a pension. Most contracts for pensions say that, should inflation rip, the pension fund does not need to be able to match inflation above 5%: the fund has some discretion after that. People have read these contracts and said, 'That is fine, we do not need to invest in the event that inflation would rip, we only need to invest to cover 5% inflation.'

Therefore what we do is we have matched every liability with a bond flow. In low inflationary times that might be OK. But what if we have hyperinflation, as we had in the 1970s? We would blow away everybody's pension. That is a really, really dangerous thing to have done. This is a very British phenomenon. In America you do not have LDI problems. Yet I have rarely heard people come out and say, 'This LDI is nonsense, and by the way it is hugely costly and it simply does not make sense to pretend that you can predict to the nth degree what the liability is; indeed, what you are doing investing in that way is following accounting practice, not following the purpose of pensions.

We simply do not have that debate: you need to start by having the debate. Instead, experts come up with solutions which are "precisely wrong" rather than approximately right. This is expertise that has been abused, because it is absolutely right that when you pick up a pension fund to think first and foremost about its liabilities; it is absolutely wrong for me say, 'I have got a contract here, and now I can match what it requires mathematically,' and it is really dangerous if you do it that way. So keep rasing this issue. Have the debate; write an article, push for reform.

Andrew McNally

What is the resolution?

David Pitt-Watson

The resolution I think is that we have got to get real about what are the liabilities, of DB pension funds in particular, and recognise that marked to market valuation of liabilities is not the only way of thinking about it. That would be a good start. If you want me to get controversial after that, we may need some flexibility in the DB promise: but that is very controversial.

George Dallas, Policy Director, International Corporate Governance Network

I would like to have you think about how rethinking the purpose of finance also rethinks the purpose of companies. Let us assume that your triplets each became CEOs in the Netherlands, US and UK, and if you took them into separate rooms away from each other, and if you asked, 'Why

does your company exist?' what would the different answers be, and how would that relate to the questions you are talking about?

David Pitt-Watson

I think they should be the same, George, because the ultimate ownership structure of those companies is very similar, and the chief executives of those companies would all be saying, 'I am doing this to generate shareholder value.' But intermediaries can behave very differently. If you were to go to PGGM, the second largest pension fund in Europe, for Dutch health workers, and talk to them , I think they would give you a very different view of the way that they would like to see an investee company run, than would a hedge fund manager on Wall Street. The reason they do that is they would say, 'Look, if I am going to pay health workers a pension in 30 or 40 years' time, I want that done within a sustainable economy where a profitable company is operating.' Therefore, you, as the investor are thinking about broader solutions for the hundreds of thousands of health workers and the world in which they live.

I think the hedge fund manager in New York might be more worried about what your announcement was going to be in two weeks' time so that they could trade the shares, and that that would be the only thing they were interested in. I think the person who is eccentric and wrong is the hedge fund manager. Why? Because it is our money; it is the same people's money in the hedge fund as it is at PGGM.

But then, as you think about the purpose of the underlying companies in which both these investors own shares, I am not sure it is different. If you take the perspective of the book it is to be serving all of us, over the long term because it is our money which funds the system.

George Dallas

You do not think it is companies that have different management styles?

David Pitt-Watson

I am just not sure that we need to have a radical change in the notion of what it is that companies are for. In the UK we have Section 172 of the Companies Act, I think it is quite well framed. It says that as a director you should be managing your company for the shareholders' as a whole, so if you have got somebody who owns 51% you do not just do it for them. But you do it only after having taken into consideration the effects of your actions on all the other stakeholders in the company. That allows directors a really broad flexibility in the way they manage the company. Now the law is somewhat different in Holland, because you have a two-tier board with workers, and all the rest of it, and somewhat different again in the US depending on what state of the US your company was registered in.

But in the end of the day, if we are all share owners, and if what we want companies to do is to be paying our pensions, then ultimately there is a coming together of what it is that we would all want to see a Dutch company, a British company or an American company doing.

I am also quite intrigued that some of the best examples of socially responsible companies are Anglo-Dutch and have managed to survive for 100 years with two apparently different objectives of companies, but actually have delivered rather well on both sides.

Will Goodheart, CFA

I am just wondering whether the launch of IEX and the increasing work on transparency, fees and charges, and the development of the Investor Forum, whether those recent activities give you any cause for optimism. How should the work to give finance more purpose be better governed, because it feels as though we have a lot of different people trying to get into the garden to improve the state of affairs, but sometimes working in contradictory ways in different parts of it, rather than in a coordinated fashion.

David Pitt-Watson

Good questions. First, I am actually quite optimistic, but I would have a caveat to that optimism.

If you consider the world of 20 years ago compared to the world now, particularly in terms of governance, it is a completely different place. All sorts of organisations are interested in this now. Here is one example. I chair the UN Environment Programme's finance initiative, so I was quite involved in the Paris negotiations. It is unimaginable 20 years ago that negotiators would discover the finance industry was not only on side for a strong deal, but actually wanted to do a stronger deal than the policymakers were able to agree. The finance industry was on the side of sustainability.

That is because of the many groups that have got together to nudge it in that direction; the International Corporate Governance Network would be a very good example; Share Action; Carbon Tracker; the Carbon Disclosure Project. (By the way, many of them are based in London. We should be really proud at the number of these initiatives that are based in London.)

I also see similar things in completely different fields, such as cost transparency. Groups like the Transparency Task Force. It is doing absolutely wonderful citizen action to try to address this issue, supported by work that Colin Meach has been doing through his trade union on asking for cost transparency. It has been absolutely fabulous.

There is a bit of me that says that it is with these disparate initiatives that you start, and getting the finance industry to work is a bit like getting politics to work; if people are disengaged from it, it will not work for you. If people start to become engaged in it that is the way we nudge it forward. This seeming chaos of different initiatives in different areas has worked.

If I had a bit of a criticism it would be that I am not sure that I see the regulators and the policymakers following up on this. At some stage we need to build and consolidate on these initiatives, whether it is climate change, or social issues, or cost transparency. I remain optimistic, and also it is the theme of the book: history suggests that getting finance to work requires the people to demand it, not just left to the regulators and the practitioners.

Mike Baliman, London FinTech Podcast

I agree entirely with your argument David, and it is very noble work. Going right back to the basics of finance though, I think you omitted one of the major functions of finance, which is the creation of money, and money is worth 1% of what it was a century ago, because, in essence, private banks have created it. Pension managers get away with 1% fees, because anything I invested 30 years ago I now feel is worth rather more. I bought a little flat in Maida Vale 30 years ago and I have made money. It is in this thing called money, and many times people assume that money is something real; it is not. It is just bits in a bank computer. What do you say about money creation?

David Pitt-Watson

I am not sure "creating money" is one of the functions the finance industry undertakes for the outside world, though it certainly is one of the consequences of the financial system.

I do not think that the creation of money is something that we have asked the finance industry to do; it is a knock-on effect of the finance industry, possibly a dangerous knock-on effect. We did not say, 'we need a private bank to be able to create money.' We are perfectly able of being able to create money from the Bank of England. We do not need the City of London to be able to do that for us.

That is why I have set it aside as being one of the functions or the purposes of the industry. And I would not measure how good the finance industry is by how much money it has managed to create. If it was, by the way, we know how to create more money: we just need lower reserve ratios on banks!

Mike Baliman

Do you believe that without addressing this money issue you can solve the other ones, or will you have to put some restriction on the creation of money?

David Pitt-Watson

If you were to solve some of the other ones you would have an effect on the creation of money. So, in the book we argue for higher reserve ratios for banks. Today I think we are having – (and John Vickers would strongly agree with me on this) – a silly argument about the funding of banks. Banks should be better financed; you do not need to have an extreme position on this like Adair Turner or Anat Admati. There should not be the likelihood that a bank is going to go down. If we were to refinance our banks that would slow the creation of money; that would be one of the knock-on effects, and good macro economists could tell you whether that creates a knock on effect that requires other policies to remedy.

Leon Kamhi

I have been privileged to work with David over the years. A week ago we had a Brexit vote, and I was with Remain, so I was disappointed from that point of view, but what was also disappointing is to see hedge funds and others looking at in the polls, and taking and making their best bets on the exchange rate and where that might go. Basically that is a transaction which really only benefitted themselves and any clients they might have had, and it is clear leakage from the beneficiary and, ultimately, from the investment chain. That is not the only example; there are other examples: M&A activity for example, seems not, in aggregate, to add much value., There is so much trading going on and we do not need so much liquidity. David, do you have any solution that might curtail the level of transactions that banks do and try and focus them on supporting the economy?

David Pitt-Watson

Yes. As the debate has got going, you can see lots of that stuff taking place. Hedge funds are allowed to bet on our referendum; that is perfectly okay, but you need to ask whose money they are betting? For most hedge funds, it is your and my money that they are betting. If you look at the statistics on hedge funds; again, there is in a nice study by a guy call Simon Lack, who reckons that

once you have taken all the fees from all the hedge funds – that is the ones that fail as well as the ones that do well – you would have been just as well if you put your money in treasury bonds, and you would not have taken nearly as much risk.

As a result of that study, and others, CalPERS, who simply withdrew their investments from hedge funds, would seem to me, to have the right solution to the problem. Of course, those hedge funds are very expensive to run, and it just wasn't worth it. So I am not saying close down the hedge funds; I am just saying this is our money. Is this a sensible way to think about how it is that it is going to be managed?

A similar thing would be true of a lot of the M&A that takes place.

But the most obviously wasteful activity, and one I really struggle with, is why it is that we are allowing high frequency trading. We have a Sherriff of Nottingham tax with high frequency trading. You know that NGOs like to promote the Robin Hood tax, that is a small transaction tax which we spend on development aid, or something like that, so it comes from the rich to give to the poor. This is the Sherriff of Nottingham tax, because most investors were opposed to the Robin Hood tax and said, 'Well, it is your and my pension that you are taxing, so you are taking from the them to give to the poor.' The high frequency trader, at great expense, is taking money from the pensioners to give to the rich, so that is the Sherriff of Nottingham tax.

There is lots of stuff like that that is going on. How do you stop it? You do not do that by banning it by writing another regulation. You do it by saying, 'This is your money.' This is what they are doing with your money. If we can find a voice in saying, 'We want you to do stuff that is purposeful with our money,' maybe we could get pensions that were invested in stuff that was sustainable; for the long-term and infrastructure, and all the things that we want them to, instead of very short-term instruments. Maybe we could stop people trading at quite the speed that we do. Indeed, when we first set up our pension funds, that would have been one of the things we insisted on.

Simon Thorpe, Delta2020

You mentioned FinTech very briefly, but I just wonder whether FinTech gives you any cause for optimism in terms of removing some of those agents that you were talking about.

David Pitt-Watson

Yes, some of it does. There are places where you can see financial innovation taking place as the result of new technology, and it is absolutely amazing. Look at M-PESA in Kenya. This is a mobile telephone company. Note that the traditional Kenyan banks said that poor people were unbankable. As a result, in Kenya, where there are lots of agricultural migrant workers who need to get their money back home. Farmers needed to get an armoured truck that would come with their pay at the end of every season, and then they would need to be able to get to their village, which was hundreds of miles away. Now you do it on a mobile phone; you can send it back to your family at home just by depositing the money on a mobile phone, and they can take it out: absolutely fabulous. It makes a huge difference to the world.

Other forms of FinTech, of course, could have similar beneficial consequences. But my warning would be that we have had lots of things over 130 years and as Philippon showed, it has not worked to bring any customer benefit. So if we are going to have the benefits of all this FinTech we

need to think about the institutions, (in that broad, economists' definition of the word), into which they are going to be introduced. If these are ones that are characterised by principal agent, agent, agent, agent, agent, where nobody knows what is going on, where there is complete opacity about what is going on, where there is no responsibility or fiduciary duty through the system, the same will happen it will give no benefit. In fact, maybe even worse will happen as a result of FinTech.

If this is done somewhere where there is transparency, where there is fiduciary duty, where we have thought about the institutions, where we allow competition to make sure that people who serve well succeed and those who serve badly fail, then FinTech would have huge implications. There is a 2% margin on intermediation right now; imagine if you could reduce that cost, as it ought to have been reduced, by three-quarters or something like that. Imagine what that would do to the world economy.

Andrew McNally

The competitive response to the high cost of fees in the financial industry has been low-cost indexation, which, I would argue, is also an external cost that you do not really care for. How do you think the active industry, which is your background, fights back against that?

David Pitt-Watson

Whatever happens, you have got to be honest about what your costs are.

But it is not that expensive to run an active fund; it really is not. The companies who are active managers , however, have many funds, and they are worried, if they reduce costs for one fund, what will be sauce for the goose will be sauce for the other ganders.

There are 28,000 funds that you can put your pension into in the UK, which creates cost. One of the reasons that there are that number is just another of the tricks of the trade, because people invest in those funds that are high performing. If you want to be sure you have got a fund that outperforms you start a lot of funds, so that is why we end up with 28,000. We also end up with this knock-on effect of high cost on active funds all trading between one another.

But I think a move towards low cost active funds may be starting, and may, of necessity, have to be started by people from outside today's industry participants. Such competitors start with a lot of cost disadvantages, so this is neither an inevitable, nor an overnight process.

In the meantime people are moving their money towards indexation to achieve low costs; the problem with indexation is over diversification, because nobody is minding the companies in which the fund is invested, and therefore the companies can do whatever they like. We can see that most obviously in excessive executive remuneration.

So, there are some good examples of people who are challenging the system, but you are right that indexation has got dangerous knock-on effects; meantime, we should be demanding of index funds that they are able to demonstrate how they can be good on governance.

Annette, NHS Improvement

I work for NHS Improvement; we are a regulator for the NHS, so I have gone a bit rogue coming here today. There are a lot of surprising similarities, and as a regulator we are seeing now that for a

long time the NHS has been under a lot of pressure to meet short-term financial targets, performance targets, and had really started to lose its sense of purpose. We are now looking at ourselves as a regulatory organisation as to how we need to change how we interact with the Service, and whether we need to have a more collaborative and cooperative relationship with them. I suppose I have two questions: one, is there a way that you could see regulation working in the finance sector? Can you regulate and be supportive in the same sense? Two, although there is this overwhelming recognition that things need to change, it still is not happening, and regulators and policymakers still need to change. I think I have a few ideas why that is not happening in the health sector, but why do you think it is not changing in the finance sector?

David Pitt-Watson

First of all there are lots of similarities between the “market” for financial services and that for health. I think if you were an economist you would say they were associated with the presence of “asymmetric information”: that is where the person who is giving you the service knows more about the service than you do, and therefore is in a position to be able to exploit you, and there are a lot of economics arguments on asymmetric information, which show that they can make markets unworkable.

In health we manage this quite interestingly in the UK through the NHS; there are market forces within the NHS, but they are deeply controlled, not just by regulation, but by the institutions of the NHS, which, by the way, includes things like culture and ethics. I know my daughter has talked about it as a doctor, and how much she has learned much of it by osmosis, and I can hear in what she is says about the importance of patient care and all the rest of it. We have no such rules in finance. That is one of the reasons that finance finds itself in difficulty.

So the question is, how could you put those same “rules of patient care” into finance. One of the institutions that we used to use a lot was a thing called fiduciary duty, and that means that as a financier, I need to act in good faith with my expertise for the person who I am serving. It is not entirely unlike what it is a doctor would do. A doctor should feel really bad about themselves if they are prescribing you expensive treatments for a disease that you do not have, even if they are being paid well for that. You need to get that sort of culture back into finance. I think we have allowed those fiduciary arrangements to wither in the UK in a very dangerous way. You can’t just write a rule to make this happen. You also need other ways to underpin fiduciary professionalism.

How can regulation help with this? I will be controversial on my opinions here, including amongst reformers. If I was to think about what I see as relatively good and relatively poor regulation, I am often quite impressed by a small body called the Financial Reporting Council; it is responsible for audit, it is responsible for governance, it is responsible for a number of things, and it has a workforce of about 80. It insists that it is the professional responsibility of the auditor to be able to deliver. Similarly, it has only a handful of people trying to encourage a better focus on corporate governance.

Contrariwise, if I was to look in the US, PCAOB, which has the same duties over audit, but has thousands of employees. It is big and expensive. I would reflect that the FRC is trying to get people to do the right thing in the first place, not to create ever more rules to constrain bad behaviour.

Here is another example, where we lean on regulation, rather than creating robust structures in the first place. If you talk to the Prudential Regulatory Authority, (I heard them speak a couple of years

back), and they said, ‘We manage banks on this really thin slice of equity. As a result we have however many hundreds of people working at the Prudential Regulatory Authority. If they had a 8-10% slice of equity, (which is what most academic observers might suggest was best) we would need about 20 people.’ We pay for that regulation, not just through the salaries of the regulators, but in all the complexity we have created.

So I think regulators need to start with thinking about the purpose of the industry they are regulating, and thinking about how we fulfil purpose in a holistic way, where there is a vision, with many moving parts which all of us will be involved in, as regulators, participants, customers, civil society and so on. And all of our efforts should be directed at serving customers better. Making sure that what they do with your money, is done for your benefit.

Lord Sharkey

Thank you, David. It is a melancholy reflection, certainly from my own point of view, that in the last Parliament, and so far in this one, Parliament is trying very hard to impose a duty of care on various aspects of the financial services business, and successive governments have completely rejected it. There is a sense that it is the industry itself, of course, that is in many parts reluctant to accept that. Having said all that, I would like to thank David for an enormously entertaining and very interesting conversation, and we hope that as a result of these [inaudible] we can move in some of the directions you talked about.

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