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Living off immoral earnings

"The reality.. is that banks.. support a thick layer of second tier executives, as well as legions of pen-pushing, meeting-loving, middle- and back-office workers who are paid multiples of their worth and contribution, especially compared with other industries."

- Financial Times' Lex column, January 19th, 2012.

"Stephen [Hester, CEO of RBS] is being urged by a number of people to accept the bonus and I think he will".. This person [an unnamed senior banker] added that if [Hester] turned down his bonus, it would "demoralise" staff members and would send a signal that they now effectively "worked for an arm of the civil service or a utility, rather than for a bank."

- Unnamed banker, playing the world's smallest violin on behalf of Stephen Hester.

Erik Schatzker (Bloomberg News): "$1.6 billion in compensation [at Goldman Sachs] is still a lot of money."

Nassim Taleb: "Anything above zero is too much money."

Erik Schatzker: "Why zero ?"

Nassim Taleb: "Because it is a utility. Anything you bail out, you should not be earning more than a civil servant of corresponding rank. Period."

- Nassim Taleb on Bloomberg News, Oct 18th, 2011.

'I didn't intend to accept a bonus, but I tripped and fell into it'

With thanks to The Daily Telegraph.

Contender for leading meme of our time is the idea, fast becoming conventional wisdom, that capitalism is somehow experiencing a crisis. UK Prime Minister David Cameron (or his speechwriter) suggested last week that it is now the time to use the "crisis of capitalism to improve markets, not undermine them." If we draw a straight line back in time from the current financial crisis to the dawn of the same crisis, few would dispute that it was, and is, banks carrying the smoking gun. It was banks that made questionable loans to flaky borrowers – sovereign as well as individual – and it is banks that required extraordinary levels of involuntary taxpayer support to keep them "in business", that is to say, keep their senior executives in the manner to which they have become accustomed. Unfortunately, in saving the banks from themselves, sovereign governments have now largely destroyed their own balance sheets. There is not, and never was, a free or fair market for banks. A free market would have allowed insolvent banks to fail. A free market, for that matter, would have no need of a central bank dictating monetary policy: the genius of the market is that it is perfectly capable of pricing money and interest rates in the same way it makes a price, every day, without fail, for the value of Tesco plc, crude oil or wheat. If the Prime Minister were capable of framing the problem correctly, he would have said that it was now the time to use the "crisis of statism to introduce markets". Instead, career politicians in the coalition, with no practical experience of any world other than the political, have been busily urging the rest of Britain to become "a John Lewis economy" of motivated employee shareholders. As Martin Vander Weyer asked archly in 'The Spectator', "Have you wondered why there's only one John Lewis Partnership, Mr Clegg ?" But then criticising the Lib Dems (official financial policy: join the euro zone) for economic confusion is like criticising David Blunkett for being blind.

Having said that, the 'sex-tips-from-virgins' unsolicited economic advice from Mr Clegg did inadvertently stumble upon a broader truth about the financial crisis: in large part, it does come down to ownership. Example. The two largest Swiss banks, UBS and Credit Suisse, have not exactly covered themselves with glory during the financial crisis. They've covered themselves with something, but it doesn't smell like glory. Credit Suisse stock between the start of 2007 and the end of 2011 has delivered a total return to shareholders of some minus 70%. UBS stock over the same period has done even worse: a total return of minus 82.6% (and that ***includes*** dividends). By their very nature it's difficult to comment about how genuinely private Swiss banks have performed during the crisis, but since they're not beholden to a widely diversified (read: essentially powerless) shareholder base, they can concentrate on customer service rather than on filling their boots and extracting value from shareholders. And as hedge fund manager Kyle Bass has pointed out, having unlimited liability as a partner in such a bank gives those employees a particular interest in ensuring that they don't entertain reckless malinvestments. For this reason alone, private banking groups have a higher likelihood of outliving their publicly listed competitors.

The phrase 'market failure' also crops up in David Swensen's guide for individual investors, 'Unconventional success'. The title is an allusion to Keynes' famous observation that fund managers, courtesy of endemic groupthink, tend to prefer (and to deliver) conventional failure over unconventional success. Swensen himself is famous for steering the Yale endowment through many years of impressive investment returns. He uses 'market failure' in the context of a managed fund industry that involves the

"interaction between sophisticated, profit-seeking providers of financial services and naive, return-seeking consumers of investment products. The drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: except in an inconsequential number of cases where individuals succeed through unusual skill or unreliable luck, the powerful financial services industry exploits vulnerable individual investors."

To Swensen,

“The ownership structure of a fund management company plays a role in determining the likelihood of investor success. Mutual fund investors face the greatest challenge with investment management companies that provide returns to public shareholders or that funnel profits to a corporate parent – situations that place the conflict between profit generation and fiduciary responsibility in high relief. When a funds management subsidiary reports to a multiline financial services company, the scope for abuse of investor capital broadens dramatically. In contrast, private for-profit investment management organizations enjoy the option of playing the role of a benevolent capitalist, mitigating the drive for profits with concern for investor returns.”

The financial crisis of 2007- ..? has taken the role of giant vampiric money-squids masquerading as investment banks to new levels of surrealism quite beyond the realm of satire. Not content with ripping the faces off clients, banks - not limited in the scope of their operations to pure investment banking - have now shown themselves quite adept at ripping the faces off taxpayers too. If deficit exists, it is not in free market terms, because as we have seen, no such free market exists. The deficit is a political and regulatory one.

In ‘The Puritan Gift’, the Hopper brothers identify the proximate cause for the crisis as

“an excess of borrowing by government, businesses and individuals.. Increasingly, reckless lending and borrowing – two sides of the same coin – have characterized most aspects of American society for the last thirty years..

“This abuse of credit across the whole of society coincided with, and could not have occurred without, a deterioration in corporate culture occurring in the last third of the twentieth century. In the Golden Age of Management (1920 – 1970), executives had learned the craft of management ‘on the job’ from more senior colleagues. As they progressed up the ladder of promotion, they would also absorb ‘domain knowledge’ about the activity for which they were responsible – to borrow a term favoured by Jeff Immelt, chairman and chief executive of General Electric. Starting in the late 1960s, however, a new concept appeared on the corporate scene: that management was a profession like medicine, dentistry or the law, which people were ‘licensed’ to practise at the highest level if they had studied the subject in an academic setting. Business school graduates and accountants set the pattern of behaviour; others would follow in their footsteps. In 2001 a ‘professional’ manager entered the Oval Office of the White House to take charge of the nation.”

Whether considering the managers of listed businesses or the managers of discretionary funds, investors should be well served by identifying those conforming to a moral as opposed to a purely self-interested approach. Decent moral behaviour is to a degree subjective, but as Justice Potter Stewart famously said of pornography, we know it when we see it. Reforming banking sector pay will only be the start of an overdue cleansing of the Augean stables. When banks compete properly for business and run the risk of genuine failure in so doing, the market will be on its way to being fixed. But as things stand, banks in collusion with central banks are distorting the term structure of debt markets (and through inflationism, all other asset markets too) and giving investors a delusional sense of safety with regard to sovereign bonds. Both financial signals and financial signalling are all wrong. When monetary policy rates and supposedly market-led interest rates are as low as they currently are (5 year US Treasuries yield less than 1% and 5 year Gilts barely that), it is not a sign of confidence, Messrs Cameron and Osborne, but a reflection of absolute terror on the part of the crippled banks that have been buying them in preference to any form of more constructive lending. Again, this is not a crisis of capitalism, but of state-controlled capital.

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