

#### **15-4. Lord Adair Turner: socially useful and socially useless financial activities**

Lord Adair Turner has been from 2008 to 2013 chairman of the Financial Services Authority, the British Regulator, he was also chairman of the British Committee on Climate Change. He trained in history and economics and worked for McKinsey & Co, the inventors of the stock-option and of the “asset-light” corporation; he was also once Vice-chairman of Merrill Lynch Europe.

Turner provoked a stir in 2009 with an interview for the *Prospect* magazine when he suggested that finance should concentrate on useful activities, discarding useless ones.

27 August 2009, **How to Tame Global Finance by Adair Turner**

<http://www.prospectmagazine.co.uk/magazine/how-to-tame-global-finance/>

Turner got in trouble with the financial community when making this distinction. Why? Because of a view that had been dominant within that community since the 1970s that such a distinction is not only irrelevant but dangerous. Friedrich von Hayek, Nobel Prize of economics in 1974, claimed that the notion of social justice is meaningless, Milton Friedman, Nobel Prize of economics in 1976, claimed that any concern about social responsibility would necessarily lead to totalitarianism (by which he meant communism). In their views, finance can claim extraterritoriality as far as ethics is concerned (unlike of course all other human activities). Here a few quotes from Turner’s later response:

22 Sep 2009, **Speech by Adair Turner**, Chairman, FSA, The City Banquet, The Mansion House, London

[http://www.fsa.gov.uk/pages/library/communication/speeches/2009/0922\\_at.shtml](http://www.fsa.gov.uk/pages/library/communication/speeches/2009/0922_at.shtml)

"One City practitioner declared himself 'appalled, disgusted, ashamed and hugely embarrassed that I should have lived to see someone who commands a senior and crucial important position as head of the UK regulatory regime, making such damaging and damning remarks'."

"Some commentators, responding to my interview [...], have challenged whether we can ever make such judgements about the social usefulness of economic activity. After all, they say, in a rich society there are many products and services which people buy but do not need – what of the fashion industry? What of much of media and entertainment? What of the arts? But there is a big difference. The products of the fashion industry are consumer products, consumed directly by individuals, and in a free and rich society, we should accept and indeed relish the fact that consumer choice is in part driven by fancy and caprice, by desire for luxury and style and indulgence, not by need. Products and services chosen directly by customers don't need to prove that they are useful; the fact that consumers choose them is enough."

"But nobody gets up on a Saturday morning and says 'I know it's indulgent, but I think I'll go out and buy one of those lovely new CDO squareds'. And the fashion, media, or arts industries cannot create financial instability and cause economic recessions. Financial services are different from those industries, because they are intermediate services, they are the plumbing of the economy, but a very complex plumbing, and if we get it wrong, potentially explosive."

"So we must ask searching questions about whether society is getting these crucial plumbing services as efficiently, at as low a cost, and with as little risk, as possible. Some comments on my *Prospect* magazine interview have suggested that any regulator ought to wish their industry to be as successful as possible and therefore as large as possible. That is frankly a bizarre idea: nobody suggests that it is the role of Ofgem to make the electricity industry as large as possible. Obviously if there are sustainable, valuable financial services which the world needs, we should be pleased that Britain is good at delivering them. But any idea that means that size is an objective, even if the activities are likely to harm global and UK economic stability, is absurd."

The views expressed here above are very much in the spirit of the “Stewardship of Finance” chair, of finance being at the service of the community.

Illustrations given in my lecture on **socially useful and socially useless financial activities** were borrowed from the two following speeches:

**What do banks do, what should they do and what public policies are needed to ensure best results for the real economy?** by Adair Turner, Cass Business School, 17<sup>th</sup> March 2010

[http://www.fsa.gov.uk/pubs/speeches/at\\_17mar10.pdf](http://www.fsa.gov.uk/pubs/speeches/at_17mar10.pdf)

and

**Economics, conventional wisdom and public policy**, by Adair Turner, Institute for New Economic Thinking Inaugural Conference Cambridge, April 2010

<http://www.findthatpdf.com/search-73415841-hPDF/download-documents-inet-turner-cambridge-20100409.pdf.htm>

Rather than fraud, Turner regards as the main culprit in the recent crisis our poor understanding of economic matters. Fraud does exist of course but our lack of correct understanding acts as mitigating circumstances. Turner doesn't state that economic theory is erroneous, he says that our errors derive from oversimplified interpretations of economic theory. It is however extremely hard to distinguish an erroneous theory from a theory whereof the most common interpretations are incorrect.

“... there is also a strong belief, which I share, that bad economics – or rather oversimplistic and overconfident economics – helped create the crisis. There was a dominant conventional wisdom that markets were always rational and self equilibrating, that market completion by itself could ensure economic efficiency and stability, and that financial innovation and increased trading activity were therefore axiomatically beneficial.”

Turner shows a process which leads from an oversimplified view of economics towards its stiffening into an ideology which was then implemented into policies and business practices.

“As a result, a set of policy prescriptions appeared to follow:

Macroeconomic policy – fiscal and monetary – was best left to simple, constant and clearly communicated rules, with no role for discretionary stabilisation.

Deregulation was in general beneficial because it completed more markets and created better incentives.

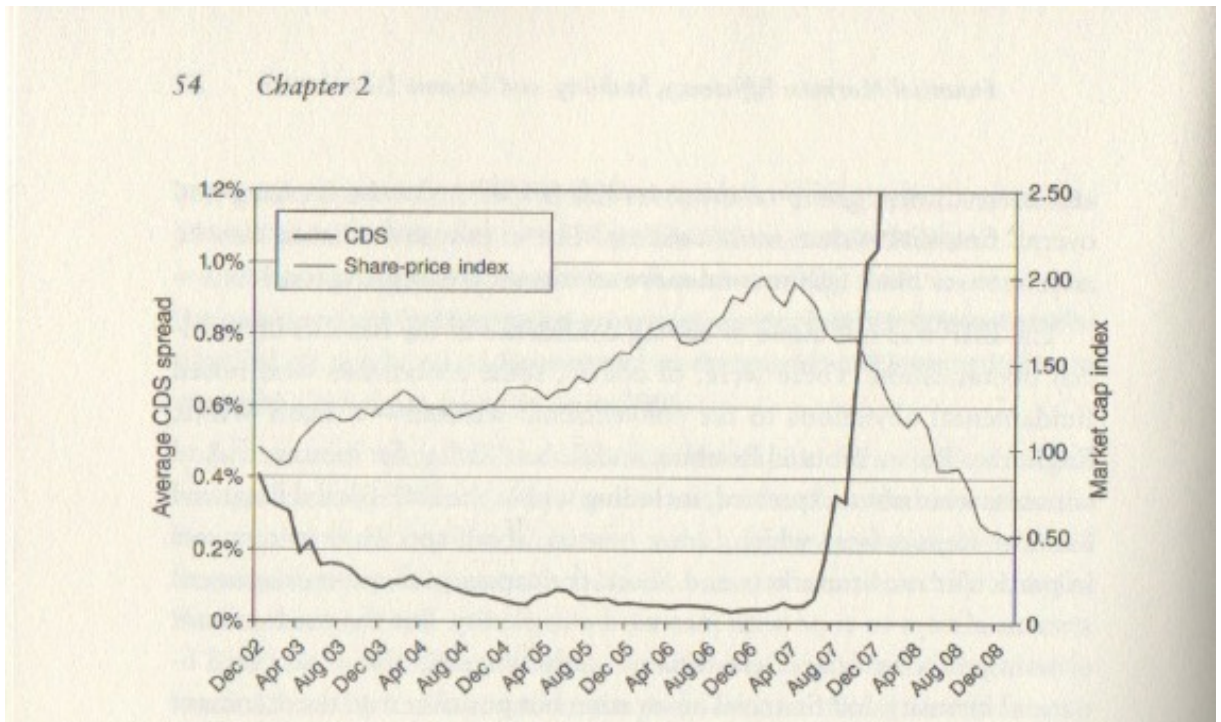
Financial innovation was beneficial because it completed more markets, and speculative trading was beneficial because it ensured efficient price discovery, offsetting any temporary divergences from rational equilibrium values.

And complex and active financial markets, and increased financial intensity, not only improved efficiency but also system stability, since rationally self-interested agents would disperse risk into the hands of those best placed to absorb and manage it.”

New financial products were introduced although there was no way the risk involved could be assessed. The rating agencies however claimed that they knew how to assess that risk - a claim justified only by their fear of losing market share to competitors, had they admitted they didn't know.

About the view that “speculative trading was beneficial because it ensured efficient price discovery”, Turner dismisses it through the example of Credit-Default Swaps, a derivative financial instrument.

A CDS acts as an insurance instrument on a potential loss associated to a debt instrument, i.e. when one has lent money. It is possible however to contract a CDS despite not being exposed to any actual loss, this being called taking a “naked” position on a CDS. Turner shows that the market-defined value of a CDS' premium, essentially determined by speculators holding “naked” positions, was at its lowest just before the crisis started in 2007. That prices represent objective value – including speculative ones – is however a linchpin of economics.



On the issue of dispersion of risk with securities backed by mortgages (home loans), there was in truth no dispersion at all: banks kept those for themselves as the returns (interest rate) promised were high (this being because of the poor quality of the borrower, requesting a high risk premium) and rating agencies guaranteed that risk on the securities was low. Accordingly, when the crisis started, risk was concentrated within the banks' portfolios themselves. Despite this, eleven months before the crisis started in February 2007, the IMF was claiming the following, which Turner quotes:

“The IMF recorded that: ‘There is a growing recognition that the dispersion of credit risks to a broader and more diverse group of investors... has helped make the banking and wider financial system more resilient. The improved reliance may be seen in fewer bank failures and more consistent credit provision.’”

Alan Greenspan, then Governor of the Federal Reserve, the United States central bank, held similar views, reminds Turner:

“Numerous speeches by Alan Greenspan enunciated a theory, a doctrine indeed, that market completion via financial innovation was delivering both economic efficiency and stability. Risk managers in banks applied the techniques of probability analysis to ‘value at risk’ calculations, **without asking whether samples of recent past events truly do carry strong inferences for the probability distribution of future events**. And in regulators such as the FSA, the assumption

that financial innovation and increased market liquidity were valuable because they complete markets and improve price discovery were not just accepted, they were part of the institutional DNA, part of the belief system.”

Turner alludes also to Goldman Sachs betting in 2008 on the downfall of mortgage-backed securities while Lloyd Blankfein, the CEO of the company, was claiming about this that he was doing “God’s work”:

“Market efficiency and market completion theories can help reassure the top executives of major financial institutions that they must in some subtle way be doing God’s work even when it looks at first sight as if some of their trading is simply speculation.”

Although they had the intuitive feeling that what they were doing was pure speculation and was detrimental to the operation of the financial system, economic theory may have convinced some of these bankers through its deluded representations that what they were doing was however beneficial.

Speculators claim that they bring liquidity to the markets. Liquidity is the ease with which a good can be transformed into money. Gold for instance is liquid (it is very easy to sell as buyers are many), elephants are not (they are a difficult sell). A debt instrument, i.e. a debt acknowledgement, has a merchant value: it can sell for money. But its saleability is determined by trust, i.e. the assurance the borrower will refund the money lent and make timely payments of the interest promised. The existence of a fair price for it is essential, i.e. a price upon which potential buyers and sellers are ready to agree. If, for a particular debt instrument, sellers ask for instance 90 while potential buyers offer only 30, there is no fair price and no transactions can take place: there is no liquidity. The condition for liquidity is expressed as a “narrow spread”, the spread being the difference between the “ask” (the price demanded by sellers) and the “bid” (the price demanded by buyers). A transaction takes place of course when the spread is nil, i.e. when the *ask* and the *bid* coincide.

### **What are the socially useful activities of banks?**

1. Intermediation between borrowers and lenders (making them meet)
2. Allowing payments from deposit accounts: transfers, withdrawals from

automated tellers, etc.

3. Insurance: insurers keep reserves in order to deal (statistically) with damages which - however costly - are rare and independent of each other
4. Maintaining a primary market for debt instruments, i.e. assuring issuance of debt obligations for corporations and nations (sovereign debt)
5. Maintaining a secondary market for debt instruments, i.e. where debt obligations can be bought and sold

In those speeches where he's addressing bankers rather than the lay public, Turner doesn't use the word "speculation", he's using the more uncontroversial phrase: "position taking". He explains how speculation acts as a predator on the economy by "extracting rent". Only a flawed representation of the economy claims that it is useful, a representation which has been disconfirmed by empirical facts.

Another, more surprising, example of a useless financial activity given by Turner is the lending of money for housing. And by that, he's not referring right away to the *subprime crisis*, he's referring to the fact that, as he puts it, one generation buys residential estate from the prior generation at an inflated price. The common explanation of such a rise is that the price of land has gone up. No social benefit derives from this process, says Turner. So if one generation has to borrow for 10 years to buy lodging, then the following generation will have to borrow for fifteen years, and the generation after, for twenty, and so on.

If you look at the credit sector as a whole in the United Kingdom, Turner says, 65% of bank loans go to mortgages. Why is this figure important? Because when you wonder what is the impact of requiring for safety reasons higher provisions from banks for their lending activities, some will say that this is damaging to productive industries as they will be starved from funding, while in fact nearly two thirds of credits go to this useless lending to households for housing. If you add lending for commercial real estate to this, then the figure rises to 75%, i.e. three quarters of credits.

As a result of this mechanism, society gets stratified into two layers: on the one side are the households who manage to buy a house and will be able in that manner to create wealth for themselves over the years, on the other side are at the bottom of the social ladder, the people who will never manage to buy residential real estate and will

not see therefore their wealth grow. Turner mentions in addition that the tax-deductibility of interest cash flows contributes to that effect.

Turner then turns to securitization of home loans and examines what happened with securities backed by *subprime* loans. The outlook was promising as at first sight *subprime* lending was lowering the threshold between the two subpopulations of who would be able to purchase a home and who would not. But it was only a financial bubble which made this possible and when that bubble burst, this part of the population that got newly access to property got wiped out.

When the credit system was able to restart it required higher down payments on the purchase of a house than was the case prior to the crisis as banks had grown more cautious about the capacity of borrowers to repay loans. This means that the threshold between the two sub-populations is not coming down but is actually set now higher than before. An article in the *Wall Street Journal* in the Autumn of 2012 claims that the only people who obtained mortgages were those who could actually buy a house for cash but are borrowing to benefit from the leverage which credit allows.

Another dimension of housing credit in the United States is the rating of households through a FICO score (from "Fair & Isaac Co.") as of their quality of potential buyers. In the logic of "risk-based pricing", the interest rate paid by a borrower reflects its FICO score. A FICO Score is supposed to reflect only character in the borrower: the capacity to refund a loan is not supposed to reflect economic circumstances but only a personal disposition: his or her moral fortitude. Thus when *subprime* borrowers were wiped out, their FICO score plummeted and their capacity to borrow was even further compromised. The distinction between "prime" and "subprime" loans corresponds respectively to a FICO score higher or lower than 620.

The evolution of demographics may however upset this logic in the future.

Turner has written a book: *Economics After the Crisis* (2013).