PERMANENT DISEQUILIBRIUM

FINANCE AS AN INDUSTRY OF SABOTAGE

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In finance people tend to work hard, very hard.

They also tend to be among the smartest around. They have to be: the system in which they operate is fast-changing, competitive and very, very tough. But working hard or being smart is not good enough in today's financial markets.

Finance is a fiercely dynamic and competitive industry, with capital markets being among the closest to what academics call the 'efficient market hypothesis (EMH)'.

Proposed by, among others, two Nobel laureates, Paul Samuelson and Eugene Fama, EMH is often misunderstood. It tends to be simplified to imply that 'markets know best'. The theory appears to suggest that markets allocate resources so efficiently and quickly that no outside intervention by governments or regulators is ever needed. EMH can be, and has been, easily ridiculed any time the market fails, as, for instance, during a financial crisis.

But this is not the most important interpretation of EMH, or even, in our view, a correct one. The idea of market efficiency has a deeper and a more sobering implication: namely, that however clever you might be, and however hard you might work, you can never beat the market. There is no way, EMH tells us, that anyone can make profits consistently over time just trading by the rules of the market. EHM prompts us to move away from the idea that financial and banking institutions have superior skills at reading economic data and financial trends and are able to understand the future better than anyone else.

As Paul Samuelson wrote: 'perhaps there really are managers who can outperform the market consistently—logic would suggest that they exist. But they are remarkably well hidden.' In finance there seems to be a unique concentration of very smart people who work very hard to make money, and very often succeed.

Before 2007, profits of 20–30 percent, even over 40 percent, of turnover were not unheard of in finance. After 2009, profits are still very high. Yet according to the theory there should not be such profits in finance. Even if we make adjustments to market-augmenting factors such as barriers to entry (to exist, banks need licences), regulatory interference (rules such as the Basle accord) and other barriers (differences in currency regimes, accounting rules, controls over capital flows, etc.), there is little in the structure of the deep, liquid and globalized markets for capital that can explain the level of super-profits the industry had become accustomed to.

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So what is the source of those super-profits? Where do they come from then? Did theoreticians get it wrong? Should we strip Samuelson and Fama of their Nobel Prizes? Perhaps not. There is, in fact, a way of making good money in finance, and it is not new. To learn about it, we just have to listen a bit more carefully to those who work the engine rooms of finance, the CEOs and those inhabiting the trading floors. They seem to have a pretty good idea of how to deal with the constraints of efficient markets. An anecdote is making the rounds in financial circles. A few weeks prior to its collapse, executives at Lehman Brothers are said to have gathered for a meeting to plan investment decisions. When a particular deal was discussed, one of the directors raised a query about a potential conflict of interest in the case. The chair of the meeting reportedly retorted: 'no conflict, no interest.' One might think that Lehman is an exception: a bank that had got carried away in the hype of easy money and eventually succumbed to its own negligence and incompetence. But Lehman is not an aberration. The 'no conflict, no interest' mantra captures a much wider phenomenon than the failings of an individual bank. It captures the mode of behaviour, the thinking, the zeitgeist, that has become standard in the industry.

We do not need to venture far to find evidence for such behaviour. A UK parliamentary committee concluded that two of the bailed-out British banks, RBS and Lloyds, 'deliberately and systematically' pushed their clients among the small- and medium-sized companies into default. Why? In order to seize their assets 'on the cheap'. In 2009 UBS, the largest Swiss bank, negotiated a deferred-prosecution agreement with the US Justice Department in a probe of tax evasion. So did Credit Suisse, and a host of other Swiss, Israeli and Indian banks. HSBC was charged with (and admitted to) failing to monitor more than \$670 billion in wire transfers and more than \$9.4 billion in purchases of US currency from HSBC Mexico. One of the premier world banks in the world admitted to facilitating money laundering for the Mexican drug cartels! HSBC joined BNP Paribas and other banks in violating US economic sanctions against Iran, Libya, Sudan, Burma and Cuba. A separate US investigation into how banks helped and abetted tax evasion brought down Wegelin, the oldest Swiss bank, which closed its doors in 2013 after 272 years in business. The bank's final act was to plead guilty to US charges of tax fraud.

On this side of the Atlantic, the LIBOR affair broke out in 2012, closely followed by Euribor and the foreign exchange rigging cases, as well as a myriad of cases of 'mis-selling'. In 2015 Deutsche Bank—whose presence in Russia dates back to 1881—had to shut its Russian securities unit under three US investigations into the bank's role in helping Russian clients launder funds and take money out of the country in so-called 'mirror deals', totalling $6 billion. In 2018 Danske Bank, Denmark's largest banking institution and one of the most respected in Europe, was revealed to have been involved in a money-laundering scheme via its Estonian subsidiary, to the tune of some $234 billion. As this book goes to press, Nordea, another respected Scandinavian bank, is facing similar allegations of enabling corruption.

Banks' less serious misdeeds include, but are not confined to, the following: misleading statements to investors involving capital-raising rights issues; abusive lending practices to small businesses; manipulation of gold prices; misreporting related to Barclays emergency capital raising; a banker stealing confidential regulatory information; collusion with Greek authorities to mislead EU policymakers on meeting euro criteria; financial engineering with the aim of moving Italian debt off balance sheet; manipulation of risk models with the aim of minimizing reported Risk Weighted Assets/capital requirements; filing false statements with the SEC and keeping false books and records, or what has become known as the 'London Whale' story.

Since 2009, American and foreign banks have paid out $321 billion in fines for misbehaviour in the US alone. This is a handy sum. It suggests to us that big, international banks are prepared to take great risks with the law. It implies that the theory that such behaviour is produced by rogue elements within banking is incorrect. The malaise is systemic.

But even if, despite the lengthy lists of cases and the hefty fines, one would still wish to describe these episodes as products of the behaviour of rogue elements, it still remains to be explained why rogue elements flourish in finance and, specifically, why they seem to flourish at a particular time and place. The crisis of 2007–9 is commonly explained as the outcome of poor global macroeconomic policies and inadequate regulatory frameworks. But what is the connection between global macro-policies and banks having lost their moral compass? If these incidences are isolated cases of failed governance, how come that the most sophisticated, mobile financial corporations which invest billions in IT to cut down a fraction of time in algorithmic trading, and in controlling asset values that reach trillions of dollars, were so poorly managed that one hand did not know what the other had been doing, for such a long time? What does failure on such a superlative scale tell us about the culture of finance and, more specifically, the business standard in the industry? Is there even a kernel of hope that such episodes are whittled down to a minimum in the future?

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THE CHALLENGE OF PROFITABILITY

Our principal contention is that finance needs to be understood first and foremost as a business. It is a simple idea. Corporate entities, and the individuals who work for them, at least those in positions of power and decision making (the proverbial 'dealmakers'), should be viewed above all else as businessmen and businesswomen. As business people, they are not beholden to any particular theory of what banking should be about. They are interested in money, in pecuniary gain. Big deal, you may think. Everyone knows that banking and finance are about money and profit. But here nuances do matter. It is the theory of how business makes money that is important. The conventional conception of a business, including banking, is of a trading entity that is subject to market discipline. Unlike manufacturing firms, which produce something, the theoretical function of financial markets is to connect borrowers and savers.

The more efficiently they do this, the better we all are. Because if trading units operate in competitive markets then they will be forced to innovate, make efficiency gains, and ultimately optimize societal resource allocation. States and governments are encouraged, therefore, to curb their natural tendency to intervene in the markets, including the financial markets.There are many problems with the theory, and they have been discussed ad nauseam in wider literature. The efficient market hypothesis is only one variant of a core assumption of standard economics. It suggests that in the long run profits in perfectly competitive markets are close to zero. As new firms enter the industry, they increase the supply of the product available in the market, forcing prices down to the point of near-zero profits. Profits, in other words, result from what economists call 'transitory disequilibria' in the market.

This is good, economics tells us, because market disequilibria occur through innovation in product, services, delivery or organization; or, alternatively, due to exogenous perturbations such as political interference.

This may indeed be the case, but this theory works provided two assumptions are met. First, it works as long as transitory dis-equilibria are generated by behaviour that follows certain norms. But what if not everyone plays by the rules? Since the implication of the theory is that those businesses who play by the rules will only be delaying and deferring the inevitable—loss of profit and collapse—while running at very low profitability in the meantime, the question arises whether those businesses may not seek a more permanent solution to their problem, a more permanent 'disequilibrium' in the markets, to ensure that the discipline of the price mechanism applies to others, but not to them.

Perhaps, and this is our core contention, the business of finance is not that different to other businesses. There is a long tradition of thought and research that shows how successful industrial or services businesses seek ways of interfering with the market, by influencing it, changing it in such a way that competition rules do not apply to them—and, ideally, exclusively not to them. Both Coca-Cola and Pepsi are happy to sing songs of praise to the competitive free market while signing exclusive deals with restaurants and venues so that the customers have no choice in the matter. Those deals do not seem to be intended to generate greater efficiency or 'optimal' resource allocations. Nor do restaurants and other venues particularly welcome such deals. These deals aim to ensure higher profitability of these two competitors, by monopolizing outlets. We know that today's hi-tech giants—Apple, Amazon, Google, Facebook or Microsoft—will do anything to control competition in their 'markets', by purchasing or destroying potential new entrants.

Why should finance act differently? Why should we think that some of the most perceptive businesspeople around, those at the helm of institutions with colossal market power, would tend to play by the rules that academic theory imagines to be the rules of the market? Like any business, finance faces the challenge of competitive markets: competition is the enemy of profits. That many banking and financial houses are highly profitable only shows us that individually and collectively they have found ways of somehow subverting those 'laws of equilibria' of economic theory.

All this is common sense. So why does economic theory still hold on to the imagined markets? Possibly because as economic theory has turned increasingly quantitative and technical, this crucial assumption about the behaviour of business as 'playing by the rules' has tended to be forgotten.

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It is quite difficult to make sense of finance today by relying on textbook approaches, wherever their intellectual or political affinities may lie. To understand the remarkable persistence and prevalence of rogue behaviour, we returned to the ideas of a school of thought, often ignored nowadays, known as the old institutional economics (OIE).

Most famously associated with the works of Thorstein Veblen and John R. Commons, this body of scholarship developed in the early years of the twentieth century in the USA, a time when American capitalism was undergoing major finance-driven changes. Observing the type of economy taking hold in the late nineteenth-century USA, and which has spread around the world since, Veblen concluded, first, that the economic system of his time was defined by the figure of the businessmen and not the entrepreneur or the capitalist. And, second, that the businessmen had become true experts in sabotaging markets. In fact, businessmen understand intuitively that efficient and competitive markets are likely to be good for customers, but competitive markets do not generate profits. Individually and collectively, the founding fathers of American capitalism did something about it.

Veblen saw that the new generation of businessmen that emerged in late nineteenth century were not specialist producers turned capitalists—which was essentially the way Marxists have tended to view these people. Nor were they essentially entrepreneurial or great innovators in manufacturing or organizations. Such people no doubt existed then as they do now. But they are a minority. The majority of businessmen were specialists, he thought, 'dealmakers,' experts in the art of buying and selling. Based on the evidence that he gathered largely from in-depth congressional studies of the nature of modern businesses, Veblen concluded that the successful businessmen of his day somehow found ways of making profits by interfering in markets.

There was always, he found, 'something in the nature of sabotage—something in the way of retardation, restriction, withdrawal, unemployment of plant and workmen—whereby production is kept short of productive capacity.' Crucially, despite the strong normative undertones to the concept, Veblen dissociated his concept of sabotage from intent, individuals or rogue behaviour. He was far more explicit in his approach than conventional economics, which suggests that market disruption is a core technique of business enterprises.

In many ways, although considered a radical, Veblen was, in effect, an early believer in efficient market theory. He also accepted that people are self-serving and individualistic. But his conclusions were based not on abstraction and deduction, but on observation of actual behaviour of the great businessmen of his era. And his conclusions were that they were expert saboteurs: they knew how to ensure that market discipline does not apply to them.

We believe there is a lot to be learned from Veblen's ideas, not least because today's regulatory and institutional architecture of the leading economies was formed largely during his time. Sabotage, or, to use Veblen's terms, something in the way of retardation, restriction, withdrawal or harming of either the clients, competitors or governments, is most probably the main source of profitability in finance and the surest way to individual bonuses and corporate profits.

In our new book, *Sabotage*, we demonstrate that in each of the selected cases we study, profitable transactions or 'deals' did not arise from a competitive edge in skills, capacity, expertise, hard work, or superior knowledge (known as theory of asymmetrical information). Instead, they involved elements or attempts at controlling markets; that is, sabotaging the price mechanism, through either internal misrepresentation of information or facts, or predatory practices that are presently or potentially damaging to clients, competitors or the government, or a combination of all three. Specifically, what is often presented as isolated scandals in the financial system falls into one of the three categories of sabotage: sabotaging the clients, sabotaging competitors or sabotaging governments (or simultaneously all three). Sabotage is driven not by malice or spite, but is intended to ensure the profitability of financial trading in otherwise efficient markets.

By using these twin concepts of sabotage and finance as business, we may achieve greater understanding of some of the otherwise inexplicable behaviour that has resulted in so many court cases, fraud investigations and hefty fines.

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Perhaps the most surprising (or depressing) part of the book lies in our conclusions: very little seems to have changed since the 1920s. During that decade, a financial boom had thrived in the context of lax or missing regulations, leading to the 1929 financial crash and the Great Depression. To date, the crisis of the 1930s remains the most important period in the construction of post-war international financial and economic governance. Many of the members of Roosevelt's 'New Deal' administration in the early 1930s, such as Alfred A. Berle, Rexford G. Tugwell, and other members of Roosevelt's 'Brain Trust,' adopted Veblenian theory of business and its commensurate philosophy of regulation.

They were explicitly concerned with business sabotage. It is only dimly remembered today that the Glass–Steagall Act consisted of a set of regulations that were aimed at limiting the propensity towards sabotaging in finance and redirecting the financial system towards its functional purpose of mediation between savers and borrowers. The argument was presented by President Roosevelt in his first Presidential address: 'the money changers have fled from their high seats in the temple of our civilization. We now restore that temple to the ancient truths.' We argue that contemporary financial regulations should return to these principles, and should incorporate the concept of sabotage in redefining and regulating the financial system in light of public welfare.

In the final part of our book we return, therefore, to the series of congressional hearings that culminated in the Pecora Report of 1934. Senator Pecora's investigation and the final report of the Senate Committee on Banking and Currency played a key role in the formulation of the Banking Act of 1933, the Securities Act of 1933 and the Securities Exchange Act of 1934, known collectively as the Glass–Steagall.

The extensive and scrupulous hearings reached the view that the crisis of 1929 was not a simple case of exuberance, mania or speculation. On the contrary, the Pecora Report, in its own words, aimed 'to expose banking operations and practices deemed detrimental to the public welfare; to reveal unsavoury and unethical methods employed in the flotation and sale of securities; and to disclose devices whereby income-tax liability is avoided or evaded.' The purpose of the report and of the ensuing regulations, it states, 'has been to lay the foundation for remedial legislation in the fields exposed.'

Over time, the report itself and the reason for the reform had been forgotten. The emphasis of financial governance shifted from regulations that aimed at curbing unsavoury methods of business practices, to safeguarding financial stability—and that is, we think, where the problem lies.

The behaviour exposed during the financial crisis of 2007–9, and the seemingly never-ending stories about malfeasance or rogue behaviour in the industry tell us something about the way the business of finance is conducted. And unless regulations begin to tackle the problem of sabotage again, the problem will persist well into the future.

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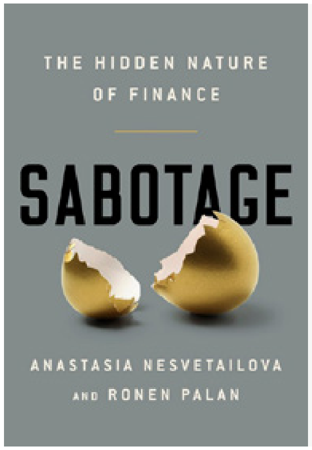

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