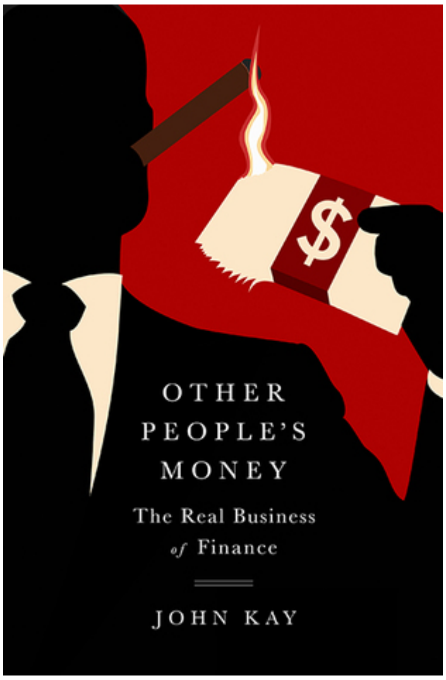


# Other People's Money: The Real Business of Finance

*John Kay*

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**Other People's Money: The Real Business of Finance** John Kay
**A Financial Times Book of the Year, 2015**
**An Economist Best Book of the Year, 2015**
**A Bloomberg Best Book of the Year, 2015**
The finance sector of Western economies is too large and attracts too many of the smartest college graduates. Financialization over the past three decades has created a structure that lacks resilience and supports absurd volumes of trading. The finance sector devotes too little attention to the search for new investment opportunities and the stewardship of existing ones, and far too much to secondary-market dealing in existing assets. Regulation has contributed more to the problems than the solutions.

Why? What is finance for? John Kay, with wide practical and academic experience in the world of finance, understands the operation of the financial sector better than most. He believes in good banks and effective asset managers, but good banks and effective asset managers are not what he sees.

In a dazzling and revelatory tour of the financial world as it has emerged from the wreckage of the 2008 crisis, Kay does not flinch in his criticism: we do need some of the things that Citigroup and Goldman Sachs do, but we do not need Citigroup and Goldman to do them. And many of the things done by Citigroup and Goldman do not need to be done at all. The finance sector needs to be reminded of its primary purpose: to manage other people's money for the benefit of businesses and households. It is an aberration when the some of the finest mathematical and scientific minds are tasked with devising algorithms for the sole purpose of exploiting the weakness of other algorithms for computerized trading in securities. To travel further down that road leads to ruin.

## Other People's Money: The Real Business of Finance Details

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# From Reader Review Other People's Money: The Real Business of Finance for online ebook

## Peter says

John Kay is a British economist who once taught economics at Oxford and is now a professor at the London Business School and an editorial contributor to the *Financial Times*. His 2015 book *Other People's Money* should be added to the long and sagging bookshelf on how the nature of the financial services industry (here denoted FSI, and including both commercial banking and shadow banking institutions) has been perverted from its original mission to its present sad state as a source of great benefits to the managers and correspondingly great costs to clients, and on the consequences of this transition for income distribution and economic stability.

This is a well-written and thoroughly researched book. As I read the book I found myself asking, "Why doesn't Kay mention this?" And then he does! To my mind, this is as thorough a book on the topic as I've read. While there is little "new" in it, it accurately details the long list of successes and failures in our modern financial system. It is an excellent synthesis of ideas that have been discussed since the 2008-9 debacle, and to my mind, it asks the right questions. The only areas in which I have much to add are the prospective questions about the future—what should be done about our problematic financial system.

<u>What Went Wrong? Part I Financialization</u>

Kay puts many of our problems at the doorstep of *financialization*, by which he means converting all characteristics of a relationship to a financial calculation. One form of financialization is rejecting the age-old idea that the proper objective of a business is to maintain a relationship among several constituencies or stakeholders (shareholders, management, labor, suppliers, customers) in favor of one stakeholder: the shareholder. This conversion began with the ascendency of the idea that the function of a business is to create value-added for the shareholder—the provider of capital. This shift was made with the blessing of the economics profession; many (but not all) economists argued that maximizing the value for the shareholder also maximized the welfare of society. The interests of labor and other stakeholders were subordinated to those of the shareholder.

Another form of financialization was the reduction of risks to a financial basis and the creation markets to trade risk. As will be detailed below, the business model of banks and other financial institutions changed from originating loans and holding them to maturity to simply originating the loans, then selling them to other institutions. Thus, the risks were sold off and the originating institution simply serviced the loan—collecting interest and dividends and paying those (less a fee) out to the new holders of the loan. This created a new primary profit center for banks and other institutions—the trading desk.

*What Went Wrong? Part II: Trading and Risk-Shifting*

Kay traces the recent financial crisis to a series of incentive failures, that is, rewards to the FSI for doing the *wrong* things. To focus the discussion, Kay asks why the top people in the FSI (the owners and managers) make so much money. He correctly notes that most of this money is not made in financing "real" trade or business activity; it is in trading fundamental securities (stock and bonds) and in creating, selling, and trading derivative securities like credit default swaps, term structure swaps, equity swaps, collateralized debt obligations, mortgage-backed securities, options, and financial futures.

In the good old days, a manufacturer wanting to build a factory would sell securities (stocks and bonds) through an investment bank to acquire the necessary funds. The investment bank, a member of the FSI, would sell the securities to ultimate investors—primarily wealthy individuals, insurance companies, and personal trusts; later on, new financial institutions like pension funds were added to the list. Bonds were often held to maturity, and stocks might be inherited over several generations. Secondary markets were limited except for government securities and some private securities (mostly railroad and other infrastructure bonds). Trading was not a source of much value added beyond the revenues received to cover the costs of trading.

But over time, and particularly with the rise of computer technology, the potential for low-cost and frequent trading increased, and institutions rose to serve the trading community. The secondary markets expanded to feed the traders, both private and quasi-public (like Fannie Mae and Ginny Mae in the mortgage markets). New trading-oriented institutions like mutual funds and ETFs developed and grew. These new members of the FSI served an important need: they provided liquidity—the ability to quickly find someone on the other side of a trade—and they allocated securities to the investors that valued them most. These innovations reduced the cost of capital for real businesses, increased the capital intensity of production, and raised labor productivity and wages.

By the 1990s we had a very different FSI. The securities sold by the factory-building business were still sold by investment banks and bought by the FSI, but the modern FSI is a trading organization, not a financing organization. At its trading desks all publicly registered securities are actively traded—the securities originated to build the factory are rapidly sold in a secondary market, a secondary market created just to allow those transactions. Fannie Mae and Ginnie Mae provided a secondary market for mortgages—hence allowing the mortgage originators (commercial banks, thrift institutions, mortgage bankers) to profit from managing the accounting and payments associated with the mortgages without having the risk of holding them; the result was an explosion in mortgage lending. The rise of markets for derivative securities that provided ways of insuring (or taking) risks has allowed an explosion in that trading. The name of the game has been *Shift the Risk*, or, put more positively, allow risks to be held by the parties most suitable for holding them (the parties that will pay the most to take the risk).

Shift the Risk can be a win-win game if both the risk-seller and the risk buyer are equally knowledgeable—if buyers really know what they're buying. Indeed, that was the pre-2008 foundation for the widespread view among economists that allowing parties to buy and sell risk was a good thing. After all, hadn't we been doing that for centuries in property insurance? Thus, with the blessings of the economics and finance professions, the urging of the potential risk traders, and the accession of the regulators, the modern FSI created a dizzying array of derivative instruments—credit default swaps, term structure swaps, equity swaps, collateralized debt obligations, Special Interest Vehicles, options, futures and other derivative securities—all designed to redistribute the risks and returns from the original securities. To Shift the Risk we added *Slice and Dice*—the creation of security bundles like Collateralized Debt Obligations. And the attention of the FSI turned to trading as new types of FSI institutions grew up the buy the risks—hedge funds, ETFs and so on.

Trading in competitive markets—and the securities and derivatives markets are as competitive as you get—is a business with razor-thin profit margins. But thin margins can be leveraged into large profits when trading is frequent and in large denominations, and when trading costs are low. All of these were achieved in the security and derivatives markets. The huge amounts traded in today's security markets, and the high frequency of trades, converted the Trading Desk from a ho-hum necessity to a major profit center. The profits accrue to the providers of the capital—the trading desk's owners—and to the managers of the trading desk. They do not accrue to the lower-level workers—the accountants, the clerical staff, and the managers of the IT department.

Hence, the very high incomes earned by owners and senior management at FSI institutions. Since so many of the top earners are in the FSI, it is significant contributor to the widening of the income distribution in the U.S. and around the world. If the golden-age FSI had remained in place, the income distribution would look much less skewed toward the "one-percenters."

What economic forces underlie the vast earnings of the FSI? At heart, the answer is investor ignorance at the retail level, stated differently, the assumption that creators and sellers of risk-sharing instruments are no more knowledgeable than the buyers is a sad fiction. Economists refer to this as *asymmetric information*. When one side of a trade knows more about the quality of the product than the other side, that information gives the "informed" trader an edge over the "naïve" trader: just as the used car salesman knows more than the buyer about the quality of car on his lot, so the creator of a Collateralized Debt Obligation knows more about the securities bundled into the CDO than the buyer. Under these circumstances, trading isn't a "fair game"—the naïve party will give up much of the income to the informed party. The result is a shift in income distribution in favor of the better-informed parties, and a consequent incentive to increase the creation of confusing products to be traded. All the institutional changes in the FSI did was to put this truth on a higher playing field by allowing the trading mentality to flourish.

<u>What to Do About It: Part I The Prospects for Regulation</u>

The traditional answer to adverse incentives and misbehavior is regulation. But… the 1933 and 1934 Securities and Exchange Acts and subsequent legislation didn't stop Bernie Madoff from scamming his clients for decades…the 1933 and 1934 Banking Act and subsequent legislation designed to prevent bank failures didn't prevent an explosion of failures after 2008… the creation of the Commodities Futures Trading Commission in 1974 didn't stop the collapse of markets related to derivative securities like swaps and options. And these massive failures are only extreme examples: there were many more examples of regulation failure, not least among them the deregulation of thrift institutions in the Garn-St. Germain Depository Institutions Act of 1982 .

Why hasn't regulation worked, and what are the prospects for the new Dodd-Frank regulation of banks and financial institutions? Here Kay strikes a very reasonable and realistic note. Regulation as it has been structured—a system of codified rules of behavior—is inherently ineffective. The primary visible consequence is the addition of new regulations when existing regulations fail to stop inappropriate behavior. Regulation is like the Ptolemaic theory of planetary motions: each time a new motion is observed—as in Mars's occasional retrograde motion—the response is not to look for an entirely new model (as did Isaac Newton), but to add another wheel or gear to the model to explain the observed anomaly using the old model.

There are three primary reasons that rules-based regulation will continue to fail. First, as Kay points out in discussing the Basel I and Basel II Agreements to establish uniform international banking regulations, rules can be "gamed" so that balance sheets can deteriorate even though the accountants say they are strong. Second, financial markets are very innovative—smart people driven by profit find new ways to do the old things, new ways that don't violate the letter of the rules; and it's the letter that regulation controls. Third, any detailed description of what you're responsibilities are necessarily fails to cover all contingencies. Anyone with teenagers knows the result. must do is

<u>What to Do About It: Part II Reforming Regulation</u>

Here Kay gets to repeat the essence of his message. Our financial system has failed to be robust—that is, righting itself after shocks hit—because it is too complex, financial systems are too inclusive in their functions, and there is little transparency. The goal should be to reestablish those properties.

Complexity has led to a long list of linkages between the originators of financial instruments and the ultimate owners. The mortgage industry is a solid example. Banks (primarily investment banks) originated loans but relied on ratings agencies to rate their quality, on mortgage bankers to vet the risks, and on commercial banks and the commercial paper market to finance their holdings—this created extra links were part of the ensuing problems. Then the banks sold the mortgages—and their risks—to others less able to assess them. Every one of these linkages failed—the use of short term loans to finance holding of long-term loans shifted risks to commercial banks and to money market funds, the abject failure of the ratings agencies to understand the risks combined with mortgage broker indifference to loan quality turned worst-case risks into reality. Kay argues for tightening these links by requiring the originating institutions to hold the loans they make, relieving them of the option to make bad loans and offload them, and by separating the shadow banking system from the commercial banking system.

Another aspect of the financial industry has been its inclusivity—banks wear too many hats. Banks (both commercial and investment) have been lenders, traders, and assessors of risk. Kay would restore commercial banks to their earlier roles as deposit takers and lenders in low-risk markets like government securities. This was a recommendation made many years ago by Milton Friedman, though for different reasons. Kay would also have risky activities performed by nonbank institutions with no Good Housekeeping certificate of approval, and financed by appropriate sources.

Transparency would reduce the possibility of asymmetric information and inform investors of risk concentrations that might be problematic. Investors would better understand their risks, would acquire them from institutions that have few links to the payment system managed by commercial banks. Trading exchanges would disseminate information about who holds the nations risky claims (an example, derivative transactions would be operated by clearing houses that would collect and report long and short positions of derivatives held by members—derivatives players would know when risks were getting concentrated, as when Lehman had massive short positions in credit default swaps.

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## Breakingviews says

By Edward Chancellor

In the laissez-faire world of Adam Smith, when individuals pursue their own selfish interests they unwittingly contribute to the benefit of all. That may be so when people are acting for themselves, as principals in the exchange. But a problem arises when they use agents to transact on their behalf. Agents, of course, have their own interests at heart. As John Kay shows in his new book, “Other People’s Money: The Real Business of Finance”, in the financial world when conflicts of interest become widely abused, all hell breaks loose.

This is not a new problem. After the 1929 Crash, Wall Street’s copious abuse of conflicts of interest was revealed by stories of insider trading, market manipulation and the flogging of dodgy securities to an unwary public. New Deal legislation created the Securities and Exchange Commission to regulate financial markets and improve company accounts. “Sunlight,” as Supreme Court Justice Louis Brandeis had earlier opined, “is the best disinfectant.” The Glass-Steagall Act of 1933 separated commercial and investment banking operations on Wall Street to protect depositors from bank losses in the securities markets.

The history of Wall Street since has been one of the progressive emasculation of New Deal regulations, together with the revival of conflicts more extensive and pernicious than ever before. During the 1970s and 1980s, most Wall Street partnerships turned into public corporations. Bankers and brokers now acted as agents for outside shareholders. Two centuries earlier, Adam Smith had warned about the dangers of such arrangements: “The directors of such companies … being the managers of other people’s money (rather) than their own, it cannot be expected that they should watch over it with the same anxious vigilance … Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company.” Smith might have been writing about Bear Stearns under Jimmy Cayne or Dick Fuld’s Lehman.

Once Wall Street’s partnerships had disbanded, bankers ceased being “long-term greedy”, as a Goldman Sachs managing partner had enjoined in the 1970s, becoming instead short-term rapacious. Long-standing relationships with clients were replaced with transactional relationships. A trading mentality came to dominate Wall Street.

Over the past couple of decades Wall Street’s conflicts of interest have become notorious. During the dot-com bubble, flaky companies were touted by the analysts whose investment bank employers were hungry for underwriting fees. In the course of the credit boom, such abuses became more extreme and far more dangerous to financial stability. Goldman and other Wall Street firms knowingly sold packages of toxic subprime securities to unwitting clients (like German banks) which had been put together with the collusion of other clients, such as the hedge fund manager John Paulson, looking to profit from the imminent credit crunch.

The banks were blind to the disastrous consequences of their behaviour, despite sitting on piles of financial and economic information. It’s easy to understand why. As the American journalist Upton Sinclair, cited by Kay, remarked: “It is difficult to get a man to understand something, when his salary depends on his not understanding it.”

The dysfunctional character of finance has many ill consequences, besides the occasional financial crisis: Capital is misallocated; savings are wrecked; a bloated financial sector attracts the best and brightest whose skills might have been put to better use in the real world; mind-bogglingly large bonuses and the perception of rewards for failure (such as the $3.6 billion of bonuses paid by Merrill Lynch in 2009 after the broker had collapsed into the arms of Bank of America) contribute to inequality and foster a sense that the system is unjust.

Occupy Wall Street may have gone away for now, but the recent appointment of a 1970s-style socialist to head Britain’s Labour Party and the rise of Bernie Sanders as a Democratic presidential contender are signs that popular discontent with finance could still upset the established political order.

What is to be done? As Kay points out, most financial regulation – including the voluminous Dodd-Frank Act of 2010 – merely adds to the complexity of the financial world. Regulation even acts as a barrier to entry, entrenching the market dominance of the leading investment banks. It fuels Wall Street’s favourite game, “regulatory arbitrage”, which, as Hyman Minsky observed, involves clever financiers finding ways to get around the letter of the law in order to engage in risky and profitable activities. What’s needed, says Kay, is structural change, such as a separation of deposit banking from investment banking, along Glass-Steagall lines. Kay also abhors the U.S. government’s tendency in recent years to impose large fines on banks, which are paid by shareholders, rather than go after the banker-perpetrators.

“Other People’s Money” is a well-written and comprehensive account of the agency problems afflicting modern finance. Kay, who lately compiled a report for the UK government on the curse of short investment horizons among equity investors, is well suited to handle this subject. Rather too much of the book covers the familiar ground of the run-up to the global financial crisis. He could usefully have devoted more space to Wall Street's long and infamous history of abusing conflicts of interest.

Kay wants to get financiers to extend their time horizons. Yet his reform proposals aren't ambitious enough. Wall Street's bonuses are paid annually out of current earnings. Yet the results of the bankers' activities play out over a number of years. More needs to be done to link fees and bonuses to these long-term outcomes.

Here's a simple suggestion which might achieve more than all the "macro-prudential" regulation of recent years. Investment bank bonuses should be held in a special account, invested in the bank's shares, until the banker's retirement. All fines would be paid out of this pool. HSBC has already made a move along these lines. If bankers were to start thinking again like partners, they might handle other people's money with greater care.

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### Kirk Houghton says

The 2008/09 global credit crunch has created a boom in books about High Finance. Making 'money out of money' fascinates and infuriates us and often reaches a peak of interest following the downturn of the business cycle. Indeed, those millionaires that got rich speculating on commodities and share prices once basked in the glory of being a stabilising influence on the world economy. Then came the 2007 sub-prime crisis, the Lehman Brothers collapse of 2008 and the 2009 recession. For one brief summer graduates in Engineering, Astro-Physics and Mathematics decided a career on Wall Street might not be their destiny.

Skip forward seven years and things are back to normal. The brightest and best seek their fortune in the City and hope to get rich speculating on various price movements in the market. What has gone wrong with the Financial Sector and what does it say about our society?

John Kay tries to answer these questions and is on a mission to challenge some of the assumptions we have about the role of Finance in the aftermath of the last economic meltdown. On the whole, his analysis is successful and enlightening.

The author's first priority is to describe how Investment Banking has moved so far away from its original purpose of providing capital for infrastructure and industrial growth. Take Goldman Sachs where underwriting debt and new equity for companies represents less than 10 percent of the bank's net revenue. In other words, 90 percent of Goldman's earnings are from Fixed Income, Currencies & Commodities (FICC) trading. This begs the obvious question: how useful is this to society?

But perhaps Kay's most poignant observation is that a lot of global businesses today need not list on the stock market to fund expansion. As he points out, Exxon Mobil invested $20 billion on infrastructure and exploration projects in 2013, all from its own resources. In the same year the company spent $16 billion buying back its own shares and paid out $20 billion in capital. In total, Exxon Mobil has spent around $100 billion in the last ten years repurchasing securities it previously issued.

So why do companies list on the stock market if they don't need capital? According to Kay, the nature of today's companies are so much different to the railways and breweries that used to pursue capital-raising projects in the early twentieth century. And the facts don't lie: operating assets make up little of the capitalintensive activities of modern enterprises such as Apple (only 3 percent). Instead, reputation, human capital and brand prestige are just as important to tech companies as plant maintenance and making the most of productive capacity. In reality, they undertake IPOs to realise value for early investors.

‘Stock markets are not a way of putting money into companies, but a means of taking it out,’ insists Kay in the iconoclastic style that characterises his writing. To be fair, he has a point: forty members of Apple became overnight millionaires when the company listed in the late 1980s. Today’s giants are similar: Google and Facebook were generators of cash early on and don’t need to raise billions to build new plant and develop infrastructure like the industrial behemoths at the turn of the twentieth century. Facebook’s ambivalent 2012 IPO prospectus more or less admitted the Board had no specific plans for the money raised on the Nasdaq.

If Main Street has been lagging behind Wall Street, the former now have a tutor in Kay. More statistics and observations follow like a swarm of bees hoping to sting you out of your ignorance. Why did Apple raise $17 billion in a bond offering in 2013 to pay a dividend? Did they need the money? No, but repatriating the cash from foreign jurisdictions would have incurred unfavourable taxes in the US.

Next in the firing line is our obsession with emulating Silicon Valley. Why do the Anglo-Saxon nations not cast an eye at the German Mittelstand for inspiration? The Stock Market value of German companies is only 40% of national income; the figure is over 100% in the US and UK. Yet Kay sees the grubby influence of Canary Wharf and Wall Street on this last bastion of productive capitalism as a defining battle for the future of Finance. Global investment banks have been trying to develop Germany’s capital markets in debt and equity for the last 30 years and may one day corrupt the nation’s world class family enterprises at the centre of its economy. Though the alchemists have had little success so far, the European Commission seems to be on the side of Goldman Sachs rather than the industrious pioneers and producers of the German heartlands.

Thankfully, the Mittelstand have shown scant interest in listing on the stock exchange and are more than capable of funding expansion through their own internal resources. Successive generations of family ownership and professional management are the key to their success. The author’s admiration for this unique producer class is clear: ‘In Britain and the USA successful medium-size businesses grow by acquisition or are themselves acquired. But this ‘hollowing out’ of the middle of the size distribution of companies has not occurred in Germany.’ (P.171) Expect Kay to write the epitaph if the vultures get their way.

If the Mittelstand represent an ideal of capitalism, the growth of Limited Liability companies mark one of its aberrations. Here we get the usual excoriations against Sandy Weil’s Citigroup and predictions that Salomon Brothers and Lehman Brothers might still be around if they’d retained their Partnership structure with their own capital on the line. The cue to rally against the demutualisation of British Building Societies is not without merit, but the author’s main criticism is how too many CEOs now prioritise their share-price above all other concerns. Hey, it’s not their money, so why not take bigger risks for the potential of huge gains?

The rise of Mark-to-Market pricing since the late 1980s has also helped the modern PLC create the illusion of wealth. Once a supporter of this valuation, Kay now admits that marking assets at full value of what they are likely to earn before their maturity is an easy way of inflating earnings and generating bonuses for senior staff. Geoff Skilling’s success in getting the SEC to authorise Enron to trade gas contracts allowed him to take advantage of this accounting method and book the full P&L in the present rather than as a steady stream of income over a longer period. Bear Stearns, Lehman Brothers, HBOS and RBS succumbed to the same temptation.

One final argument in this book that will get attention is the author’s assessment the Financial Sector has too much regulation, not too little. This is the most contentious part of the whole study and the least articulate of Kay’s judgements. Numerous pages are devoted to lamenting the evils of ‘Regulatory Capture,’ but the reader may still wonder what this means, other than an ill-defined advantage today’s lobbyists have over regulators.

Fortunately, Kay’s analysis of ‘Regulatory Arbitrage’ is far more intelligible. What do the growth of London’s Eurodollar market of the 1960s and the Credit Default Swap of modern times have in common? Answer: They both evolved as a way of circumventing the law. The former, known as Regulation Q, is a good example of unintended consequences. Government intervention after the Great Depression put a limit on the level of interest US Banks could offer depositors; capital reserve requirements were also high. But money lent to American banks from European institutions escaped the provisions; therefore, the former could recycle funds via Britain to get round the rules. Result: US banks found a way to pay higher interest on deposits and London banks enjoyed renting out their services for a commission. Alas, the Eurodollar market emerged thanks to a regulatory loophole.

It’s easy to see why Other People’s Money made the Longlist for the 2016 Orwell Prize. The author is an Economist with a gift for explaining complex subjects and making Banking & Finance accessible to a wide audience. However, a tendency to pre-warn the reader certain topics will be covered in more depth in later chapters can be repetitive (and confusing) and Kay, like many others, does not offer a convincing definition of Derivatives. This is a shame because he should excel at describing a ‘Put’ option on a Forward Contract or articulating the intricacies of an Interest Rate Swap. (Topics that still baffle me.)

The ‘Financialisation’ of our society may be irreversible unless western civilisation lapses into war, but until then today’s Science Graduates may continue to deprive us of their productive skills to trade commodities instead. The end of ‘Casino Banking’ is nowhere in sight, but stopping Investment Banks using deposits from their Retail operations is the first of many changes that need to happen if we are to prevent another crash. Like John Plender, Sir Mervyn King and Alex Brummer, the author is keen to add his name to the list of prophets lamenting the inevitability of the next crisis.

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## Hadrian says

The charges of 'financialization' is not a new one when it comes to critiquing the international political economy. The idea that the financial sector is produces nothing of value for the economy and is, in effect, a high-stakes gambling ring with other peoples' money is not a unique complaint. But this is not the ramblings of some Chavist apparatchik, but an Oxford-educated columnist for the Financial Times.

In that respect, he realizes what a financial system can and should do - it serves as a system to settle transactions, to produce funds for investments, to manage personal assets, a means to reduce market risk, and so on. However, Kay recognizes that the financial sector is becoming increasingly ineffective at all of these, and is becoming largely a means to increase the salaries of its employees and escape the consequences in case of a market crash.

Kay's view is not just to attack, but to determine how all this happened. He traces individual legislation and the structural degradation that made all this possible. It is an ethical failure, says Kay, where a system is based upon trust has done so little to earn that trust over the past few decades.

As such, mere 'regulation' is not enough in the sense of regulation. What Kay proposes is comprehesive structural reform, ranging from limiting the types of assets banks hold to better means of prosecution. There is a tendency in human behavior to gamble, but Kay hopes to reduce the opportunities for this to take place, and to crack down on moral hazard with fair punishment.

Other People's Money is a clear and broad analysis of the structural causes behind the 2008 crash, and what is necessary to prevent another disaster on that scale. This book is the sort of reassurance, both in its positions and in its prescriptions, that something can be done.

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### Meghan says

This was a slog for me. I don't think I picked up much that I didn't already know. But I didn't disagree with anything Kay wrote. I think it's an important message and I'd recommend it to anyone trying to learn more about the topic, so I can't bear to give it anything less than a three. It's just overkill for anyone steeped in this industry.

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### Daniel Wright says

Essential reading for anyone whose life is in any way affected by the finance industry - i.e. everyone.

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### Popup-ch says

The history of financialisation.
John Kay mourns the era when bank managers knew their customers and schmoozed them on the golf course. In the run-up to the financial crisis they were replaced by intermediaries who slice up mortgages into tranches that are sold off to the highest bidder, creating a short term windfall for everyone in the business, but adds no added value. Instead of a long-term relationship between the butcher, the banker and the candlestick maker, which relied on internal trust, the 'financialisation' has replaced this interpersonal trust with heavily regulated risk calculations - that can be gamed by the legions of skilled manipulators that has shot up in recent decades.

Using German phraseology, he bemoans the conversion of *Gemeinschaft* into *Gesellschaft*, by which he implies a loss of collective responsibility and instead an increased focus on the bottom-line only.

Today's banks are incredibly leveraged and heavily focused on trading, with results best described in Taleb's vocabulary of 'Black Swans' - high-impact unlikely events; and with the increased amounts of trading, these unlikely events become almost inevitable.

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### Nick says

A large number of people suspect that most of what goes on in the finance industry is both slightly dodgy and fundamentally pointless, with very large rewards going to people who do nothing to make anyone's lives better. However, not many people outside the industry have enough knowledge of what it does to make this argument this from an informed perspective.

John Kay is extremely rare - someone who understands the industry, an insider in many ways, but also a fierce critic of most of what the industry does. And yet he more or less shares the view of the person in the street when it comes to the pointlessness of much of modern finance.

Kay argues that there is nothing special about the finance industry and it should be judged as we would judge any other industry. For example: what does the airline industry do? Provide metal tubes that get us from A to B in varying degrees of comfort with a high degree of safety. What does the finance industry do? Facilitate payments, pool risks (insurance), provide capital to businesses ("search"), look after our assets ("stewardship"). In short, provide services to the 'real' economy.

And yet, how much of what the finance industry does is concerned with doing those basic jobs better? Very little. The modern finance industry, argues Kay, spends most of its time trading with and talking to itself. The City of London sucks in some of the best brains in the country, and yet these brains are employed in activities which do nothing to improve the level of service the finance industry offers its clients and customers.

How have we got into this mess? In a word (a somewhat ugly word), financialisation. Kay sums it up with a simple but effective metaphor. All the real assets in the country - businesses, household savings, property - are owned by somebody, and these claims can be represented by bits of paper (the fancy word is "securities"). It doesn't take much insight to see that however many bits of paper you create to represent these claims, and however fast these bits of paper change hands, the real wealth of the country - its businesses, savings and property - doesn't change in value.

Yet the finance industry is obsessed with creating more and more bits of paper - not just securities, which are claims on assets, but derivatives, which are claims on claims on assets. The root cause of the financial crisis was that banks, which had once confined themselves to accepting deposits and making loans, thought they could boost their profits through creating and trading ever more complex financial instruments, completely forgetting about the nature or quality of the underlying real assets (most notoriously, sub-prime mortgages).

Kay uses Charlie Munger's word "febezzle" for the illusory wealth that is created through such activities. Much of banking profits in the years leading up to the financial crisis was febezzle, a theft from the future that had to be paid back rather suddenly (mostly by the humble taxpayer, who footed the bill for bank bailouts in the US and Europe). But in an industry where the incentives of executives and employees are short-term, there is a culture of "I'll be gone, you'll be gone."

Another key theme of Kay's book is the replacement of trust relationships in finance with transactional relationships. Financial advisers became salespeople for financial products. Bank managers who looked you in the eye and decided if you were good for a loan (and who you might see on the golf course) have been replaced by credit checks and other impersonal processes. Individuals looking to buy a financial product such as a fund, who might once have relied on a trusted company or person to do the job for them, are deluged with reams of information in the name of 'transparency' - information they don't read, can't understand, and lack the ability to interpret. Regulators aim to 'maintain confidence' in the financial system, rather than help to create the sort of system that would inspire confidence.

Not all developments in the industry have been bad - and trust relationships were sometimes abused. However, it is hard to argue with Kay's main point that the lengthy and obscure chains of intermediation in the finance industry do little to benefit the individuals and businesses who are the ultimate users of its services. Nor does the relentless pursuit of market "liquidity" - the ability to trade large amounts of securities quickly - which is something the vast majority of individuals and businesses neither want nor need.

The remedies imposed on the finance industry after the 2007-9 crisis were the right ones in the short term, says Kay, but absolutely the wrong ones in the long term. Banks should have been forced to split off their deposit and lending businesses, which enjoy explicit or implicit guarantees from the taxpayer, from their trading activities, which do not need or deserve such guarantees. If this had been done, there would be less need for the reams of regulation that burden the industry without protecting its users.

Part of the problem, though, is that politicians of all persuasions have bought into the idea that finance is special, untouchable - the goose that lays the golden egg. Before the financial crisis, Gordon Brown was one of the most ardent advocates and admirers of the City of London. George Osborne was barely out of his job as Chancellor when he received an offer to work for one of the world's largest asset managers. In the US, the links of both the main parties with Wall Street run deep.

If only key people in government and at the financial regulators read this book, that might be a useful first step to building a finance industry that works better for the people it is supposed to serve.

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### Athan Tolis says

I never thought I’d say this about John Kay, but he needs to stop writing. He’s no longer current. He’s unnecessarily running the risk of destroying what is a tremendous legacy of contribution.

His heart is 100% in the right place.

His grasp of the principles is as strong as ever.

There are tons of ideas here that are undeniably correct, first and foremost the idea that managers of businesses must be personally liable for wrongdoing. I also could not agree more with him when he notes that the end of Glass Steagall was a disaster, because it allowed banks to (fraudulently, Enron-style) apply mark-to-market accounting on years of Net Interest Margin, generating one-time “profits” and necessitating further bloating of balance sheets to keep the gravy train going.

His knowledge of finance, however, is stuck in 1986, give-or-take, and in this book it truly shows.

In no particular order, here’s a list of stuff he gets half right / he almost gets to and then somehow contrives to totally miss / he gets flat wrong. It pains me to write it, it feels like I’m stabbing in the back an old friend, I’ve practically grown up reading and looking forward to reading his FT column, but some things need to be said:

1. He correctly notes that we have a problem of too many regulations, not too few (for the simple reason that banks find ways around the regulations and this spawns even more regulation etc.) He also correctly notes that High Frequency Trading is a scourge.

He fails to observe that High Frequency Trading did not exist (and could not exist) before a misguided piece of regulation that forced banks to give their clients the “best” price on execution of equity trades, opening the way for electronic operators to show very aggressive prices in tiny amounts, and then frontrun orders in proper size.

2. He correctly notes that we let the crisis go to waste by failing to nationalize the banks. He also correctly notes that the banks are not really “too big to fail” but actually “too interconnected to fail.” Third, he also correctly notes that banks’ trades are predominantly with one another.

It would not have been an enormous mental leap to conclude that if the government of the US had nationalized the top 5 banks, the 1 quadrillion worth of derivatives (he counts them as 400 trillion, but the LCH alone has cleared more than 500 trillion) would collapse by more than 50%, leaving them to face Deutsche, Barclays, BNP, UBS and CSFB, pretty much. Chances are this will happen in the next crisis, of course. The world can’t wait for 30 year AUD/JPY basis swaps to mature, can it?

3. Page 233 he quotes a captain who saw the bad weather coming and took a two-day detour to avoid it, only to face questioning about the delay. He’s full of praise for the captain. Why exactly, then, was it fraudulent to sell to mortgage holders insurance against the fact that they might not be able to pay their mortgage, especially as he admits that if he was born 30 years later there’s no way he could afford his house? Was it written anywhere that (i) house prices would keep going up, that (ii) interest rates would keep going down, that (iii) the UK economy would go from strength to strength? I’m NOT saying all PPI claims are unfounded, no. But to reject PPI outright as fraud is very much an ex-post type of analysis of the type he decries.

My view on this topic is actually rather sinister. I consider the PPI compensation and the swaps compensation to be a massive, stealthy and cynical act of fiscal policy. The UK government owns RBS and Lloyds and forced them (and along with Barclays and HSBC) to make very significant and very targeted payments to the UK public to help with the economic recovery, all while preaching austerity.

I know what I’m talking about. One of my former employers hired (at the behest of the UK government) outside consultants who painstakingly went through every swap ever done with an SME and split them into three categories: the ones where we were clearly at fault, the ones where the counterparty clearly knew what they were doing and the ones where there was room for discussion. The answer from the government, who had asked us to hire the consultants, came as a surprise: you’re paying out on all of them!

4. LIBOR he judges on the cosmetics, on the language of the traders on what they believed to be private chats. If that is your basis for passing judgement, you really need to keep your judgement to yourself.

The story of LIBOR is simple enough you can summarize it in ten lines: once upon a time (Kennedy administration) there was a tax imposed on interbank transactions in the US. So US banks started making all their interbank payments in London. If you knew you would need money, you’d “go low” in your submission and if you knew you would be lending money you’d “go high.” Next, two things happened: (i) interbank lending decreased in importance and (ii) the derivatives market went from zero to 1 quadrillion dollars. That’s one million billion dollars. And derivatives largely set off of LIBOR. Banks, being profit-maximizers (tut tut) realized that they should “go low” if they were net-net across all derivatives fixing that day “paying” today’s LIBOR and “go high” if they were net-net across all derivatives fixing that day “receiving” today’s LIBOR. So they did exactly that. The end.

As John Kay correctly notes, transactions between banks are a large multiple of transactions between banks and their clients. This is actually a protection for clients. Because they borrow money against LIBOR, clients collectively pay LIBOR fixings. The fact that all these derivatives exist means the banks’ incentive that would normally have been to always set LIBOR high is mitigated by the fact that transactions with corporate clients are a small part of every bank's book. I'd go one further and say corporates fully know this, and that's how come they are comfortable fixing their issues off of LIBOR!

Finally, even if LIBOR was to some extent "a fiction" since it was by 2007 a dog that was largely wagged by its tail, IT WORKED. It became the best barometer for the crisis, and the index central banks followed the closest, until of course Goodhart's Law intervened and turned it all meaningless. These days only the cross-currency basis swaps remain meaningful, for instance currently demonstrating that American firms are issuing in EUR to take the losses on the interest against the profits they have parked in Europe that they can't repatriate without paying tax.

5. He correctly notes that banks like Barclays and Deutsche show something like 70 trillion (with a T) of derivatives on their balance sheet and equally correctly notes that adding a smidge of equity (dunno, 5 billion with a B) is neither here nor there in terms of making the banks safer.

He fails to mention (perhaps he does not know) that the Swiss government has found a solution to this problem: it has asked Swiss banks to count as an asset the winnings on those derivatives and to count as a liability the losses on those derivatives when it comes to computing the necessary capital they must hold. I'm not familiar with the specifics, but this simple measure was enough for both UBS and CSFB to exit the business of trading pretty much instantly. So we HAVE an answer to the problem of "too many derivatives," it is to account for them properly. It is the willingness to apply this solution that is lacking.

Next, he notes correctly that the French and German governments have failed to force BNP and Deutsche to recognize losses because the banks in those countries are part of a rather dirigiste approach to government, and further correctly notes that the flow of money is (i) declare a profit (ii) pay it out as bonus to top management and even does the math to show the UK government collected GBP 17 billion in income tax receipts from banks' employees versus GBP 2 billion in corporate tax.

And then he fails to make the ultimate connection: The coffers of the treasury are the single biggest beneficiary of the "bezzle." Exactly why would the UK government crack down on a business that pays everybody's bills? All they will do is allow it to carry on and slap banks with continuous fines for both real crimes and made-up crimes like using bad language in your communication while you are doing the very job you were hired to do, in the hope of getting a large bonus, that the government positively wants you to receive so it can get its hands on 45% of it.

On the same subject, he further notes that most of Europe's business is done out of London. For every corrupt manager of a Bulgarian airline's air hostesses' pension fund or Greek journalists' pension fund (guess how the word got out) you also need a corresponding derivatives salesman out of London to sell him the requisite off-market derivatives. 45% of the bonus the derivatives salesman got (past tense, because all those pools of money are now fully depleted) ended up in the UK Treasury's coffers, thank you very much.

In summary, it is the WILLINGNESS we lack and not the ways. The Swiss have shown the way.

So that's five examples where John Kay got the basics right and failed to get to the correct conclusions because he no longer understands how the business works. I could go on, but you get the point.

I can forgive him the above, he's doing his best. Reading his book actually helped me clarify some things in my mind because he lays it out nicely and, much as he fails to reach the correct conclusions, it's largely all there and a reader who knows about modern banking can put it all together.

In his old age, however, John Kay is taking some rather nasty turns:

He claims the Halifax went down because it entered trading. Erm, no. The Halifax / HBOS went down the traditional way, selling mortgages. You can say that this coincided with the time when they decided to trade bonds (they hired the unbelievably intelligent and skillful Linus Wright to run that business for them, inevitably from Goldman Sachs, and he continues to do very well trading for himself under the umbrella of an American hedge fund) but to say that the Halifax went down because it espoused trading is plain wrong. And John Kay has to know that’s wrong. They went down lending money against overpriced real estate to people who could not meet their mortgage payments. Period.

Most toxically, John Kay has turned against the essence of capitalism, which is the validation of price via the arm’s length transaction between two willing counterparties.

We should not subsidize these counterparties’ trading.

We should not use these prices to value long-term banking transactions.

We should not deify the traders.

But we should equally not be surprised when a player who can turn around a zero-sum game (for example, what Maradona did for Napoli in the Campionato) can negotiate for himself terms superior to everybody else’s put together. We should celebrate it for traders every much as we do for footballers. Provided, of course, we are not stupidly subsidizing their potential losses.

To cut a long story short, “Other People’s Money” is a Luddite’s manifesto, urging us to go back to 1986. And it gets worse the deeper you go. It cost me valuable reading time I won't get back.

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### Yalman Onaran says

It's a very good overview of why the business of banking has become a burden to modern economy, forgetting about its original raison d'etre of allocating financial resources for economic activity.

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### Marrije says

Fantastically angry and informative dissection of how financialisation ruined the economy, and what is to be done. It went a bit over my head at times (this stuff is pretty complicated), but sticking with it paid off. Kay's very British sense of humour also helped.

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### Mehrsa says

This book is readable, informative, and most importantly, it is right. The author accurately describes and diagnosis some of the major issues in finance today. I had a few disagreements with him--especially on whether banks are indeed different than other enterprises (his main point is that they are not), but I think his points are all supported by academic studies and especially by reality.

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### Oleh says

An insightful description of values that are predominant in the modern financial industry. What do these people do for living? How does it affect us?

A highly interesting title. Complements the Big Short movie.

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### Christian says

A challenging book for me since I lack an economics or finance background, but incisive and understandable when read carefully. I liked how Kay took nothing for granted and always questioned why things function as they do today. He never accepted that a theory or method's position on the historical timeline was a marker of its place in an evolutionary march. The finance sector currently operates in unnecessary, damaging, and self-serving ways that don't follow the purpose of finance: to facilitate the support of business growth; to maintain a payments system; to fund retirements; and to restore infrastructure. The current finance sector seeks to simply exploit perceived or real flaws in the market for financial gain.

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### Brooke says

I would have learned a ton if I paid better attention. But it was kind of hard to follow since I'm not familiar with banking history and regulation. The main takeaways are that the finance world is greedy, impersonal, and overly complicated to the point that it's hard to regulate. Bankers used to have personal relationships with the people who the took loans from and loaned to. Now, bankers and financiers are playing with the money of people they don't know or feel beholden to. The mentality is "I'll be gone, you'll be gone," meaning lets get in and make as much money as we can't without regard to future consequences. And they seem get away with that because the U.S. government is always there to bail them out. Also because individuals rarely if ever see legal consequences or punishment. If a stock broker or whoever does something dishonest, the institution gets fined, and the individual walks away, no jail time.

I'd recommend this book if you are committed to sitting down and really thinking this one through. Don't listen on audio 1.5x speed.

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