Reforming the Risky Financial System

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John Kay has written a highly readable and often incisive book about the way in which the financial practices dominating much of the world have evolved into a highly dysfunctional system that generates ever greater instability, inequality and waste. As someone who has not only academic credentials but considerable practical experience in the financial sector, and who believes in the benefits of the free market in many contexts (for example, Kay’s The Truth About Markets, 2003), his trenchant critique of the contemporary financial world is all the more credible. He draws on historical, economic, legal and psychological perspectives to analyse modern finance, focusing especially on the experiences of the United States (US) and the United Kingdom (UK); and he offers proposals for reform.

Modern Financial System

Kay’s main aim is to show how contemporary financial institutions fail to serve well the primary purposes of a financial system: (i) to process payments, (ii) to channel savings to productive investments, (iii) to help manage personal finances across the lifecycle and across generations, and (iv) to manage and transfer risk. As he demonstrates, the primary business activity of large financial institutions is no longer financing growth in the real economy; instead it is exchanging financial claims (“bits of paper”) with peer institutions. The explosion in the volume of financial activity in recent decades is largely attributable to the development of markets in derivatives and swaps; innovations that arose in the interstices of the financial system partly as a means of avoiding government regulation. The profits made nowadays in finance represent in large part not the creation of new wealth but the financial sector’s appropriation of wealth created elsewhere in the economy, which enriches most of all the executives and senior employees of that sector.

Unlike many critics of the modern financial system, Kay does not believe that the most fundamental problem is the sheer size of financial institutions; instead, he locates the essence of the problem in the extraordinary complexity of contemporary financial activity. In a particularly insightful section of the book, he notes that complexity, and the specialisation and interdependence to which it gives rise, have greatly increased human productivity in many domains; but one consequence of greater complexity is greater potential for instability and crisis. A system in which everything depends on everything else, and in which there is little tolerance of error, lacks robustness. As Kay observes,

Engineers responsible for interactively complex systems have learned that stability and resilience require conscious and systematic simplification; modularity, which enables failures to be contained; and redundancy, which allows failed elements to be by-passed (p 264).

Yet by the time of the global crisis, financial systems had shed all semblance of the simplicity, modularity and redundancy that had characterised them decades earlier.

As Kay argues, the sheer complexity of contemporary financial finance both enables and results from excessive risk-taking on the part of financial market participants. The escalation of financial riskiness and complexity has led not only to greater economic instability, culminating in a global financial crisis, but also to excessive compensation of financial executives and their key employees. And the extraordinarily high salaries (and bonuses) paid out in the financial sector have led to a huge waste of talent, as many of the ablest graduates of first-rate educational institutions pursue careers in finance rather than in the real economy. The mushrooming of the financial sector is clearly a major source of growing inequality within the affluent nations of the world; and, as Kay pithily notes, inequality of rewards so incommensurate with inequality of contributions to society are especially corrosive of the social order.

The counterproductive evolution of financial systems has been justified, if not also stimulated, by the market-fundamentalist theoretical approach dominating modern financial economics. As Kay points out, this approach treats risk like any ordinary commodity, for which different people have different preferences or different capabilities. Voluntary trade between people with different attitudes towards risk is then assumed to benefit both parties, just as voluntary purchase or sale of goods and services benefits both parties. Indeed, the case
for a free market rests fundamentally on the notion that market transactions are necessarily positive-sum in nature.

But this approach to financial economics ignores the potential for information asymmetry, which obtains when people entering a market have different degrees of relevant information and knowledge. As Kay points out, markets for securities are largely based on precisely such differences in information and knowledge between the two parties to a transaction, rather than on differences in preferences or capabilities. This helps to explain why finance can be so hugely profitable, and why its profitability is a very poor indicator of its contribution to well-being. Derivatives, credit default swaps, and other such innovative financial instruments are essentially a form of gambling, in which one party gains what the other loses. Free-market principles cannot be adduced to justify such zero-sum transactions.

Kay argues persuasively that financial profits have very little to do with contributions to general welfare, either as an incentive to provide useful goods and services or as a measure of the contribution of the financial sector to society. He suggests that the surge in financial innovation in recent decades has served mainly to intensify the dichotomy that Marx described between material physical assets and the superstructure of securities that represent or relate to them. Echoing John Maynard Keynes, he goes on to note that the returns to a security depend on the assessments of other traders, as opposed to the fundamental value of the assets on which they are based, to an extent that varies inversely with the length of the time horizon. In contemporary capital markets, therefore, “what matters is not so much... knowledge of business, economic development, global politics—as knowledge of the activities of other market participants” (p 110).

**Proposals for Reform**

In the latter chapters of his book Kay turns to proposals for reforming the dysfunctional contemporary financial system. He is sceptical of the ability of government regulators to rein in the financial excesses he has documented, because—as he rightly observes—regulators never have as much relevant information as those whom they are tasked to regulate, and they never have the resources needed to offset the financial and political clout of their adversaries. Nor does Kay believe that simply breaking up financial institutions into smaller-sized units would make much difference. Instead, he calls for wholesale structural reform aimed at separation and simplification of financial activities, along the following lines.

Fundamentally different kinds of financial activity should be separated from one another. First of all, deposit banking should be walled off from investment banking. And because deposit-banking liabilities are largely guaranteed by government, taxpayers who foot any ultimate bill for this guarantee should also be protected from loss. This means that deposit-banking assets should be limited to government borrowings and good-quality housing. Investment banking should be characterised by short, linear chains of intermediation, and their asset managers should have the skills needed to channel savings into good investment opportunities in the real economy and to help households transfer wealth across their own lifetimes and between generations. Finally, and most crucially, both deposit and investment banking should be walled off from speculative trading. (This latter part was the underlying intent of the Volcker Rule, proposed to US President Barack Obama by former Federal Reserve chair Paul Volcker in the wake of the financial crisis of 2008; but only to a very limited extent was it actually implemented.) As Kay puts it: “Financial intermediaries can act as custodians of other people’s money, or they can trade with their own money, but they must not do both at the same time” (p 272).

Efforts around the world to reduce the explosion of risk-taking that generated the financial crisis have fallen far short of the kind of structural change that Kay has in mind. Moreover, he envisages considerably more than the separation and simplification of financial activities. He calls for nothing less than a change in the industry culture: “anyone who handles other people’s money, or who
advises how their money should be handled, should demonstrate behaviour that meets standards of loyalty and prudence in client dealings and avoids conflicts of interest” (p 260). He is nostalgic about the trusting, long-term relationships among financial market participants more characteristic of the much simpler financial environment a half century ago. But it is far from clear how such trust could be restored, even if all of Kay’s proposed reforms were implemented.

The structural changes in modern finance that Kay advocates could only be legislated in the context of a wholesale change in the political climate of countries such as the US and member states of the European Union. Kay is well aware that, “the finance sector is today the strongest of all industrial lobbies” (p 286) and that “little progress can be made in reforming finance unless the influence of money on politics is reduced” (p 287). Indeed, he goes on to opine that “the situation in the US seems beyond repair” (pp 287–88). In other countries, like India, there might be a better chance.

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