



What Is The Purpose Of The Finance Industry?

David Pitt-Watson, Responsible Investing Co-founder, Federated Hermes

Monday, 28 November 2022



A Word From Today's Chairman

Charlotte Dawber-Ashley

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Today's Agenda

- 11:00 – 11:05 Chairman's Introduction
- 11:05 – 11:25 Keynote Presentation – David Pitt-Watson
- 11:25 – 11:45 Question & Answer



Poll

How much more efficient is the finance industry than 100 years ago?

- Much worse
- A little worse
- About the same
- A bit better
- Much better



David Pitt-Watson
Responsible Investing Co-founder
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Finance as though Purpose Mattered

David Pitt-Watson

Z/Yen

November 2022

One Word to Describe the Financial System



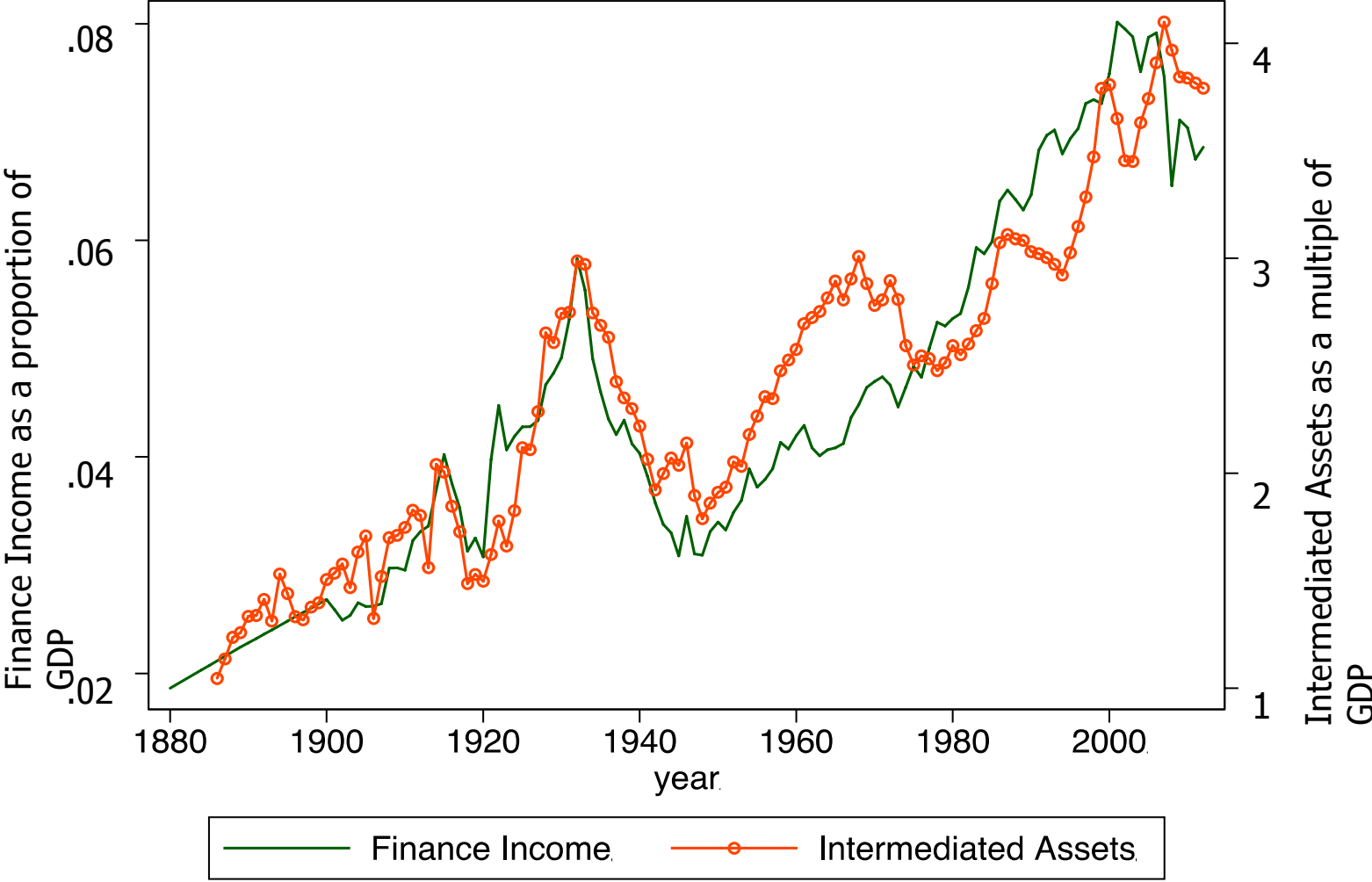
Today, practitioners, regulators, academics and others hardly consider the the purpose of the finance industry and whether it fulfils that purpose well.

- General agreement the purpose is to serve the outside world.
- Little interest in specific functions.
 - Competition and markets will “cause the changes in institutional structure to evolve towards greater efficiency” [Merton]
- The key functions of finance might be defined as:-
 - The safe-keeping of assets; Providing an effective payment system; Pooling risk ; Intermediation – matching the users and suppliers of money
 - And the industry is accorded huge powers to help perform these functions
- Combined create valued products, (bank accounts, loans, pensions, permanent capital)
- Without them we will struggle to address the challenges of the 21st Century: ESG not an ‘add on’

The framework of analysis is neo-classical economics, and (mainly Gaussian) statistics

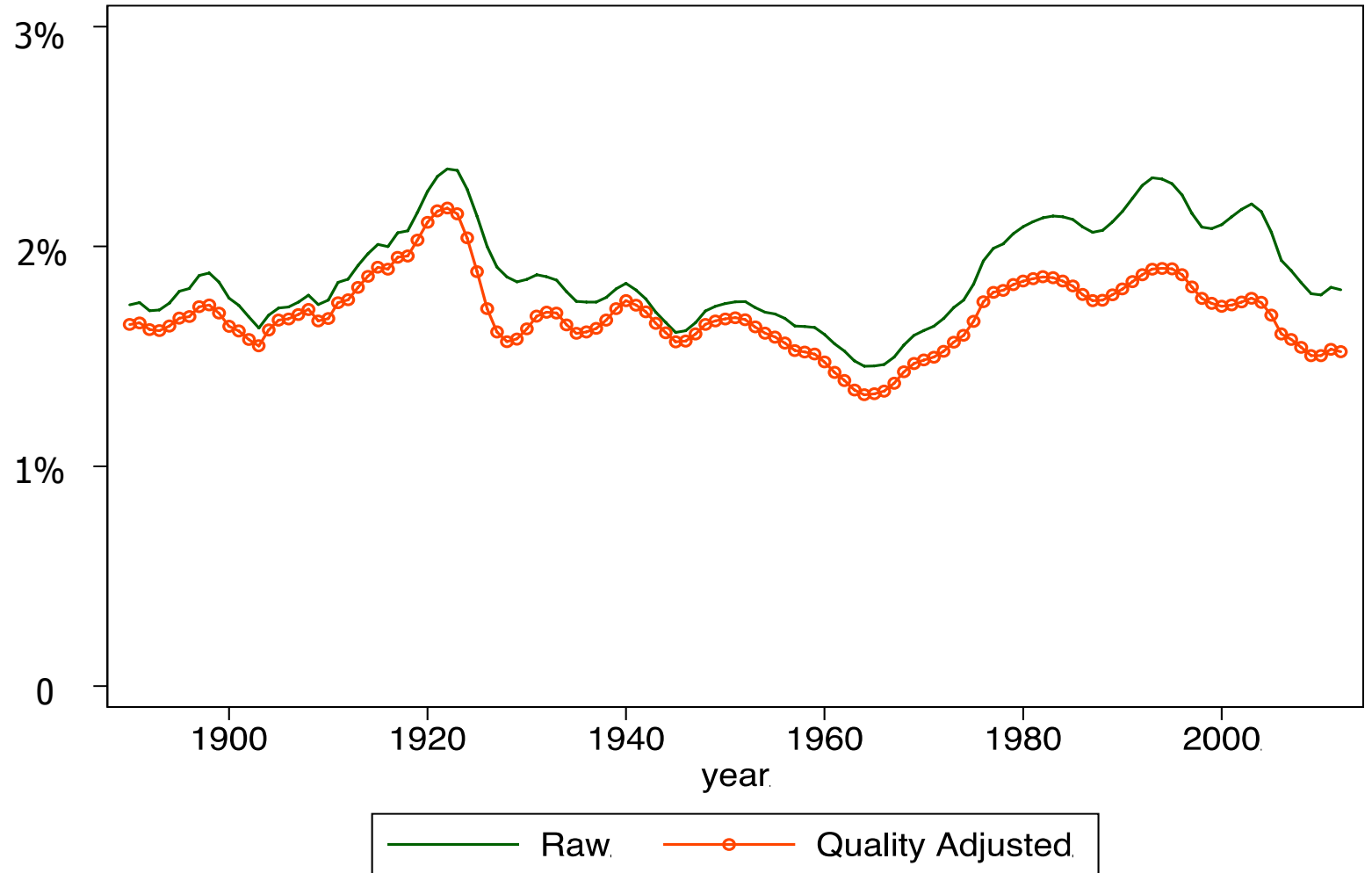
- These are not “wrong”. But they are inadequate to explain the operation of a human system whose characteristics are not Gaussian, and where efficient market institutions do not magically appear
 - If you start from there you will discover yourself overregulating.
- We need a discipline which better describes how an effective financial system works, and how it can best fulfil its purpose
 - Because the evidence of failure is compelling

Finance industry income and intermediated assets have grown as a percent of GDP



But the cost of intermediation has shown no increase in efficiency

Percentage cost of intermediating assets: USA



Why might this be happening?

- Zero sum game activity
- Asymmetric Information. Exists in lots of industries.
- Under these circumstances, markets will not be welfare maximising
 - “Not socially useful” (Turner)– Financial innovation “vastly increased the rent” (Volker)
- It doesn't require bad people for the system to fail
 - Compare to early medicine
- And there are important services which we fail to provide

An example of how important might this be?

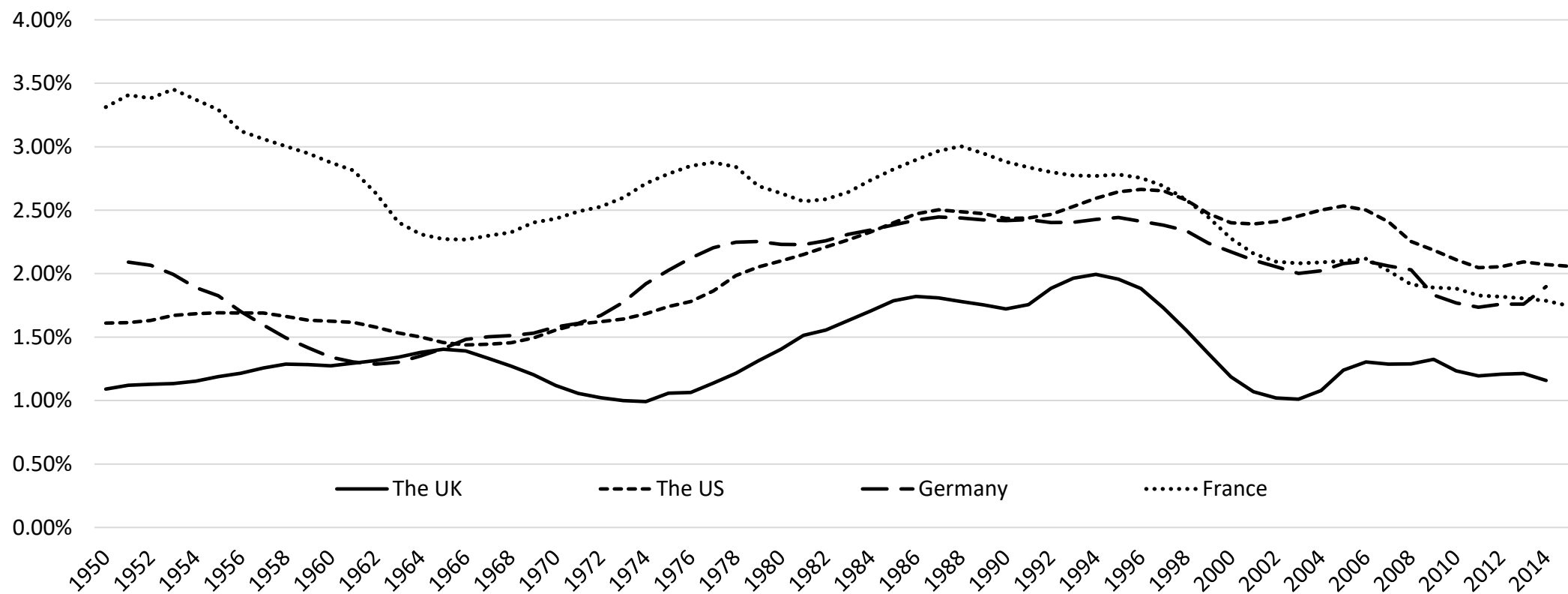
- The purpose of a “pension” is to provide for a “reliable income from retirement until death”. Today it is impossible for private sector employees to access such a pension cost effectively.
- This is because, until last year, it was illegal to establish a “pension” fund unless benefits are guaranteed.
- All studies show that collective pensions, with some flexibility, can offer more reliable outcomes to savers and deliver 30%+ higher incomes in retirement
- About 6% of GDP is spent on private pensions. A purposeful pension system would therefore add the equivalent of 2% of GDP to national welfare

“If I ruled the world”

- The finance industry is of the most profound importance to the prosperity of the UK. Indeed, it is important everywhere. You will not find a rich country that does not have a sophisticated finance industry or a poor one which does.
- The purpose of the finance industry, like every industry, is to serve the outside world; to keep money safe, to help us transact, to allow us to share risks. And above all, “to take money from point A where it is, to point B where it is needed”. We know where it is needed. New investment, new companies, new homes, green homes, green energy, research and innovation. Equity and loans for new and expanding businesses, mortgages which allow our kids a place to live in. And government needs loans for investment in schools and hospitals, in roads and railways. British people need insurance, pensions which will give them some comfort in retirement, bank accounts.
- Finance, in other words, is at the heart of our economy, and the heart of the global economy. I want to see the industry succeed, not just in terms of profit or employment, or the taxes it pays. It should succeed because it demonstrates it is ever better at fulfilling its purpose, serving national economies, serving the world economy. (btw, Britain excels at finance)

Unit Cost of Intermediation (Bazot, G)

Figure 8: Unit cost of financial intermediation



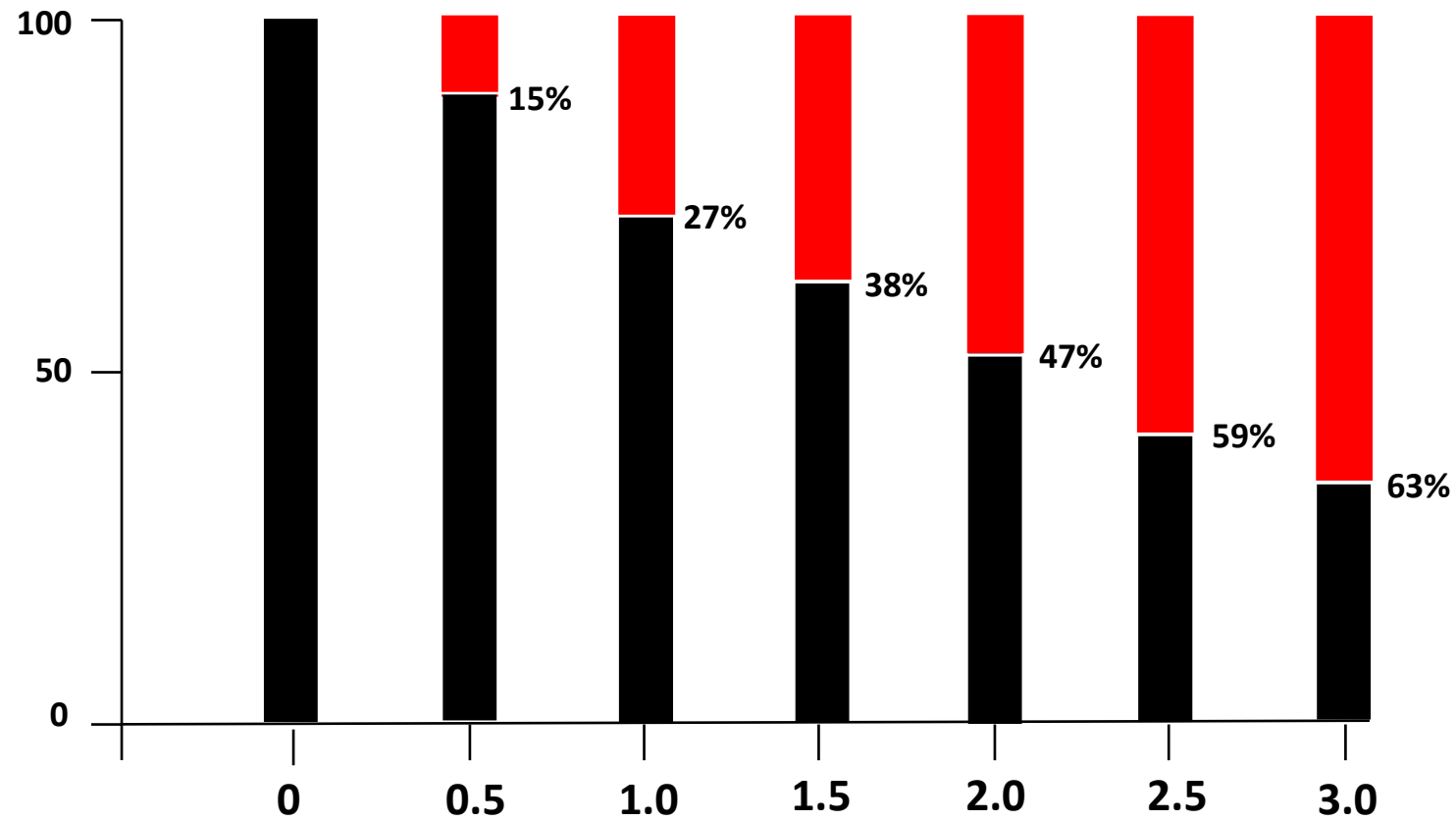
So what needs to happen?

- Accept that on the evidence, Turner and Volker may be right, and that finance requires a rethink.
- A new perspective. A “paradigm shift”. Start with Purpose.
- The starting point in researching, studying and measuring finance (and risk)
- The starting point for regulating finance
- The way we practice finance
- But remember the baby. The extraordinary thing is not Philippon. It is that the system can exist at all
- Some approaches at Cambridge University

How might this be done?

- Can we promote a new lens through which to study finance
 - In every lecture, seminar and class
 - New? Existing?
- Can we integrate (at least some of) the purposeful services that need provided into our teaching—and the “institutions” needed to provide them
 - A pension which will last until the day you die (Holland)
 - An understanding of what costs are paid to the finance industry
 - An understanding of the role of fiduciary duty and how it is realised
 - The responsibility of the financial system in corporate governance
- Can we create and share the material necessary to teach Purpose as the core objective of the finance curriculum
 - Textbook? Cases? Other teaching material.
- What challenges would that present?
 - Would we need a similar taxonomy?
 - Should we build from existing practice? Might the Core Economics programme gives us an idea
- Who might curate what we are doing?
- How can we recruit others to our mission. Who would be most significant?
 - Recruiters? Regulators? Ranking Agencies?
- It is worth a lot

Why do costs matter?



- Pension
- Example

An example of how important might this be?

- The purpose of a “pension” is to provide for a “reliable income from retirement until death”. Today it is impossible for private sector employees to access such a pension cost effectively.
- This is because, until the new Royal Mail plan is approved, it is illegal to establish a “pension” fund unless benefits are guaranteed.
- All studies show that collective pensions, with some flexibility, can offer more reliable outcomes to savers and deliver 30%+ higher incomes in retirement
- About 6% of GDP is spent on private pensions. A purposeful pension system would therefore add the equivalent of 2% of GDP to national welfare

Why is it particularly important for the Purpose of the Company?

- It is to the finance industry that the stewardship of our public companies is entrusted
 - Appointment of directors/auditors
 - Incentives
 - Policing Section 172 for “all shareholders after consideration of stakeholders”
- All the evidence suggests that the industry should be using its powers to promote purpose from the companies whose shares it owns on behalf of its clients.
 - Currently this role is (very) inadequately served. Despite protestations of the importance of doings so
 - Search for (zero sum) alpha, over beta
- Purposeful companies cannot thrive if capital markets push in another direction
 - . Yet some stewardship powers essential to protect permanent capital holders, and hence fulfil purpose.
- Thus the need to align a purposeful financial system with purposeful companies
 - Purposeful capitalism?



Comments, Questions & Answers





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- Wed, 30 Nov (11:00-11:45) Has The Banking Sector Run Out Of Options For Further IT System Energy Savings?
- Tue, 06 Dec (15:00-15:45) Quantum Computing In 20 Minutes
- Tue, 06 Dec (17:30-19:00) A City Of London & Birkbeck Roundtable Discussion On The Unseen Influences On Climate, Sustainability And Resources
- Wed, 07 Dec (11:30-12:15) Ireland - A Model For Fintech Collaboration

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